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REGULATING BANKRUPTCY BONUSES

JARED A. ELLIAS*

In 2005, the perception that wealthy executives were being rewarded for failure led Congress to ban Chapter 11 firms from paying retention bonuses to senior managers. Under the new law, debtors could still pay bonuses to executives—but only “incentive” bonuses triggered by accomplishing challenging performance goals that go beyond merely remaining employed. This Article uses newly collected data to examine how this reform changed bankruptcy practice. While relatively fewer firms use court-approved bonus plans after the reform, the overall level of executive compensation appears to be similar, perhaps because the new regime left large gaps that make it easy for firms to bypass the 2005 law and pay managers without the judge’s permission. This Article argues that the new law was undermined by institutional weaknesses in Chapter 11, as bankruptcy judges are poorly situated to analyze bonus plans and creditors have limited incentives to police executive compensation themselves.

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INTRODUCTION

When large firms struggle financially, they usually restructure by firing employees, cutting the pay of those who remain, and cancelling promised pensions. While these measures are often necessary, they can seem unfair when highly paid senior managers do not appear to share in the pain.¹ This unfairness became a major public issue in the early 2000s, as formerly-high-flying titans of corporate America like K-Mart, Enron, and WorldCom filed for headline-grabbing Chapter 11 bankruptcies and subsequently paid millions of dollars in bonuses to senior managers.² The

1. See Gretchen Morgenson, *MARKET WATCH: A Year's Debacles, From Comic to Epic*, N.Y. TIMES (Dec. 30, 2003), <https://www.nytimes.com/2003/12/28/business/market-watch-a-year-s-debacles-from-comic-to-epic.html> (condemning American Airlines for negotiating wage concessions from its unionized workers while rewarding top executives with retention bonuses and setting aside \$40 million to protect the pensions of executives); see also David Olive, *Many CEOs Richly Rewarded for Failure; They Didn't Suffer as Stocks Tanked in New Economy*, TORONTO STAR, Aug. 25, 2002, at A10.

2. These bonus plans were very controversial because the payment of bonuses in bankruptcy is a public event, leading to press coverage. See Bloomberg News, *Bankruptcy Court Approves FAO Executive Pay Plan*, N.Y. TIMES (Feb. 15, 2003), <https://www.nytimes.com/2003/02/15/business/company-news-bankruptcy-court-approves-fao-executive-pay-plan.html> (noting an approved FAO Inc. executive-retention plan paying \$1.1 million in bonuses); see also Seth Schiesel, *Revised Contract for WorldCom's New Chief Executive Wins Approval from 2 Judges*, N.Y. TIMES (Dec. 17, 2002), <https://www.nytimes.com/2002/12/17/business/revised-contract-for-worldcom-s-new-chief-executive-wins-approval-from-2-judges.html> (detailing the executive compensation plan for the CEO of WorldCom, which was approved during the company's bankruptcy); Rhonda L. Rundle, *FPA's CEO Received Salary Increase Five Days Before Chapter 11 Filing*, WALL ST. J. (Aug. 3, 1998), <https://www.wsj.com/articles/SB902097584655373000>. Senator Charles Grassley, Republican of Iowa, summarized the populist argument against bankruptcy bonuses in a 2012 letter demanding that the Department of Justice police them more vigorously: "Corporate directors, executives and managers who

ensuing public outrage contributed to a growing sense that the economy had become rigged in favor of high-level executives who prospered no matter how poorly their companies fared.³

In 2005, Congress responded to this public outcry by banning Chapter 11 debtors from paying retention bonuses to high-level executives.⁴ This legal reform eliminated part of then-existing bankruptcy practice, as the largest firms typically paid retention bonuses shortly after filing for bankruptcy on the theory that bonuses were needed to keep employees working hard to turn the firm around.⁵ However, the reform did

were at the helm of a company as it spiraled into bankruptcy should not receive bonuses of any kind, let alone excessive bonuses, during a reorganization or liquidation.” Mike Spector & Tom McGinty, *U.S. Is Asked to Review Bankruptcy Bonuses*, WALL ST. J. (Feb. 13, 2012), <https://www.wsj.com/articles/SB10001424052970204642604577218033661586936>.

3. See, e.g., Kristine Henry, *Beth Bonus Called Good Way to Keep Salaried Steel Talent*, BALTIMORE SUN (Jan. 6, 2002), <https://www.baltimoresun.com/news/bs-xpm-2002-01-06-0201050169-story.html> (detailing executive retention plans paid out in high-profile Chapter 11 bankruptcy cases); Nelson D. Schwartz, *Greed-Mart Attention, Kmart Investors. The Company May Be Bankrupt, but Its Top Brass Have Been Raking It In*, FORTUNE (Oct. 14, 2002), http://archive.fortune.com/magazines/fortune/fortune_archive/2002/10/14/330017/index.htm. Many bankruptcy lawyers at the time were also upset by this behavior, fearing that managers were abusing Chapter 11 to extract excessive compensation at the expense of public confidence in the bankruptcy system. See generally Robert J. Keach, *The Case Against KERPS*, 041003 AM. BANKR. INST. 9 (2003) (discussing issues with key employee retention plans (“KERPS”) at the American Bankruptcy Institute’s 2003 Annual Spring Meeting).

4. See *In re U.S. Airways, Inc.*, 329 B.R. 793, 797 (Bankr. E.D. Va. 2005) (“Congressional concern over KERP excesses is clearly reflected in changes to the Bankruptcy Code that will become effective for cases filed after October 17, 2005.”); see also Dorothy Hubbard Cornwell, *To Catch a KERP: Devising a More Effective Regulation than §503(c)*, 25 EMORY BANKR. DEV. J. 485, 486–87 (2009) (discussing the amendments to the Bankruptcy Code); Rebecca Revich, *The KERP Revolution*, 81 AM. BANKR. L.J. 87, 88–92 (2007) (explaining how Congress restricted the ability of Chapter 11 debtors to “retain management employees under programs generally referred to as Key Employee Retention Plans (KERPs)”). In support of the ban, Senator Edward Kennedy delivered a memorable floor statement condemning “glaring abuses of the bankruptcy system by the executives of giant companies.” *In re Dana Corp.*, 358 B.R. 567, 575 (Bankr. S.D.N.Y. 2006) (noting statement of Senator Kennedy in support of the amendments and discussing the legislative history of the amendments to section 503 of the Bankruptcy Code). It is worth noting that beyond the arguments over the propriety of paying bankruptcy bonuses, some observers questioned their efficacy, noting, for example, that after Kmart implemented a KERP plan, nineteen of the twenty-five covered executives left within six months and that Enron’s KERP failed to staunch the outflow of talented employees. Keach, *supra* note 3.

5. The executive compensation restrictions were a very minor piece of a much larger reform, as part of a bill called the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (“BAPCPA”), Pub. L. No. 109-8, 119 Stat. 23 (2005) (codified as amended in scattered titles of the U.S. Code). While this paper is the first to study the executive compensation restrictions in this degree of detail, many other papers study other aspects of this reform. See generally, e.g., Kenneth Ayotte, *Leases and Executory Contracts in Chapter 11*, 12 J. EMPIRICAL LEGAL STUD. 637 (2015); Pamela Foohey et al., *Life in the Sweatbox*, 94 NOTRE DAME L. REV. 219 (2018); Robert M. Lawless et al., *Did Bankruptcy Reform Fail? An Empirical Study of Consumer Debtors*, 82 AM. BANKR. L.J. 349 (2008); Michael Simkovic, *The Effect of BAPCPA on Credit Card Industry Profits and Prices*, 83 AM. BANKR. L.J. 1 (2009).

not ban Chapter 11 debtors from paying any type of bonus to senior managers—only bonuses triggered by a manager’s mere continued employment. Under the new regime, Chapter 11 debtors can pay bonuses if they convince a bankruptcy judge that the bonuses are “incentive” bonuses, or bonuses managers would only receive if they accomplish specific, challenging performance goals.⁶

This Article offers the first comprehensive analysis and empirical study of how the 2005 law changed corporate bankruptcy practice. As further explained below, the data suggest that the reform appears to have had little substantive effect on executive compensation.⁷ The evidence suggests that this is primarily due to two flaws that undermine the reform. First, the new law only regulates payments characterized as bonuses during the period when firms are in Chapter 11 bankruptcy. Firms can easily sidestep the new law by paying managers before or after the bankruptcy case, and many appear to have done so.⁸ Second, bankruptcy law institutions have struggled to administer the law. A rule that bans retention bonuses while allowing incentive bonuses requires bankruptcy judges to make fact-intensive determinations about the “challengingness” of a

6. For example, a Chapter 11 bonus plan might require management to increase earnings or move through Chapter 11 quickly. *See infra* notes 46 and 57 and accompanying text.

7. Bankruptcy lawyers largely share this skeptical view of the efficacy of the reform. *See, e.g.*, Eric Morath, *Bankruptcy Beat: ABI Poll Casts Doubt on Bonus Reforms*, WALL ST. J. (Oct. 21, 2009), <https://blogs.wsj.com/bankruptcy/2009/10/21/abi-poll-casts-doubt-on-bonus-reforms> (reporting survey results that a majority of respondents agree that the reform was not effective in limiting executive compensation). These poll results are consistent with other anecdotal evidence in the popular media. *See, e.g.*, Nathan Koppel & Paul Davies, *Bankruptcy-Law Overhaul Has Wiggle Room; Limits Set on Key Executives’ Pay, but Door Is Wide Open on Bonuses Linked to Achieving Certain Goals*, WALL ST. J., <https://www.wsj.com/articles/SB114342447370208718> (last updated Mar. 27, 2006) (“[B]ankruptcy lawyers say companies have managed to sidestep some of the law’s provisions.”). Lee R. Bogdanoff, a founding partner of the law firm Klee, Tuchin, Bogdanoff & Stern LLP in Los Angeles, was quoted by Bloomberg News as saying that “[t]he amendment to the code changed the means, but not the value of these plans . . . It’s just changed the way you get there, not necessarily how much management gets at the end.” Steven Church, *Buffets Rewards Managers Who Put Chain in Bankruptcy*, BLOOMBERG NEWS (Apr. 5, 2012), <http://www.bloomberg.com/news/articles/2012-04-05/buffets-rewards-managers-who-put-chain-in-bankruptcy>. A former Department of Justice official charged with supervising the bankruptcy system argues, “Congress took a stab at righting the problem and companies quickly found a way to circumvent their intent.” Mike Spector & Tom McGinty, *The CEO Bankruptcy Bonus*, WALL ST. J. (Jan. 27, 2012), <https://www.wsj.com/articles/SB10001424053111903703604576584480750545602>. A contemporaneous working paper provides suggestive evidence that at least some firms contracted around the reform. *See* Vedran Capkun & Evren Ors, *When the Congress Says “PIP Your KERP”: Performance Incentive Plans, Key Employee Retention Plans, and Chapter 11 Bankruptcy Resolution* (Feb. 15, 2009) (unpublished manuscript), https://people.hcc.edu/ors/wp-content/uploads/sites/24/2018/02/PIP_your_KERP_20140104.pdf (“By trying to suppress KERPs, which were deemed to be ‘self-dealing’ plans proposed by unscrupulous managers, BAPCPA appears to have led to ‘structural arbitrage.’”).

8. *See infra* Section III.B.1.c.

proposed bonus plan. Unfortunately, bankruptcy judges often lack the information and expertise necessary to perform this inquiry.⁹ Although creditors would appear to be well-situated to assist the judge and scrutinize executive compensation themselves, they have little economic incentive to quibble over relatively small bonuses, because doing so might anger the managers with whom they need to negotiate more important Chapter 11 issues.

This Article proceeds as follows. Part I describes how bankruptcy bonuses became a frequent subject of public outrage and how Congress changed the law in 2005 to alter the process through which Chapter 11 debtors pay executive bonuses. Part II explains potential flaws in the design of the reform and develops hypotheses about how those design flaws arguably doomed its implementation. Part III summarizes the sampling and data gathering methodologies and then presents evidence that illustrates the design flaws predicted in Part II. One question that this Article does not answer is whether there actually was a problem that needed fixing prior to the 2005 reform. Most Chapter 11 attorneys appear to believe so, but this is an empirical question that is impossible to answer with available data. However, because the evidence presented in this Article does not support the view that Chapter 11 executive compensation was improved by the reform, Part IV argues that Congress should rethink the 2005 reform.

I. THE RISE OF BANKRUPTCY BONUSES AND THE 2005 BANKRUPTCY REFORMS

Part I first summarizes how the phrase “bankruptcy bonus” entered the public lexicon and why these bonuses became so controversial. Next, I explore the legislative history of the 2005 reform, before discussing the ways in which the new law altered the ability of Chapter 11 debtors to pay bonuses to their executives.

A. THE RISE OF BONUSES AS A PROMINENT FEATURE OF CHAPTER 11 BANKRUPTCY

For the first two decades of the Bankruptcy Act of 1978, bonus plans approved by bankruptcy judges were not an important part of bankruptcy

9. See *infra* Section III.B.2.b. The fact that bonuses created by the post-2005 incentive bonus plans are similarly sized to the pre-reform retention plans casts doubt on the notion that these bonuses came with the additional risk that would come from truly challenging performance goals. Michael C. Jensen & Kevin J. Murphy, *CEO Incentives—It's Not How Much You Pay, but How*, HARV. BUS. REV., May–June 1990, at 138 (outlining the difficulty of adequately linking executive pay to compensation while simultaneously not appearing to overpay executives).

practice.¹⁰ The new Bankruptcy Code contained few provisions dealing with executive compensation, and bankruptcy courts routinely granted uncontroversial motions to pay employees their promised salaries.¹¹ This quiet period ended in the early twenty-first century, as Chapter 11 debtors and the law firms advising them developed a practice of paying retention bonuses outside the ordinary course of business after filing for bankruptcy.¹² Generally, firms that wanted to pay retention bonuses would file a motion asking the judge to approve “Key Employee Retention Plans,” or “KERPs,” which created schedules of payments of retention bonuses.¹³

10. See Sreedhar T. Bharath et al., *The Changing Nature of Chapter 11* at 12–14 (Fisher Coll. of Bus., Paper No. 2008-03-003, 2010), <http://ssrn.com/abstract=1102366>.

11. See, e.g., Motion of Debtor and Debtor in Possession Pursuant to 11 U.S.C. §§ 105, 507(a)(3), 507(a)(4) and the “Doctrine of Necessity” for an Order Authorizing It to Pay: (A) Prepetition Emp. Wages, Salaries and Related Items; (B) Prepetition Emp. Bus. Expenses; (C) Prepetition Contributions to and Benefits Under Emp. Benefit Plans; (D) Prepetition Emp. Payroll Deductions and Withholdings; and (E) All Costs and Expenses Incident to the Forgoing Payments and Contributions Filed by Debtor-in-Possession Bush Indus., Inc. at 13, *In re Bush Indus.*, 315 B.R. 292 (Bankr. W.D.N.Y. 2004) (No. 04-12295).

12. *In re Allied Holdings, Inc.*, 337 B.R. 716, 721 (Bankr. N.D. Ga. 2005) (“KERP programs such as the one the Debtors seek approval to implement have become customary uses of estate funds in large business reorganizations.”); see also David A. Skeel, Jr., *Creditors’ Ball: The “New” New Corporate Governance in Chapter 11*, 152 U. PA. L. REV. 917, 926–28 (2003) (discussing innovations in executive compensation and the evolution of bankruptcy bonuses); Mechele A. Dickerson, *Approving Employee Retention and Severance Programs: Judicial Discretion Run Amuck*, 11 AM. BANKR. INST. L. REV. 93, 96–97 (2003) (discussing the prevalence of retention bonuses offered in Chapter 11 cases); James H. M. Sprayregen et al., *First Things First—A Primer on How to Obtain Appropriate “First Day” Relief in Chapter 11 Cases*, 11 J. BANKR. L. & PRAC. 275, 299 (2002) (suggesting Chapter 11 debtors consider bonus plans as part of bankruptcy planning). A contemporaneous press account suggests that bonuses became a common feature because many of the formerly high-flying tech firms had high bankruptcy costs associated with a prolonged stay in Chapter 11 that would leave little value for creditors in the event creditors were forced to hire new managers. In effect, the inability of Chapter 11 to preserve the going concern value of telecom firms provided managers with the power to extract holdout value in exchange for remaining at their desks. One investment banker was quoted as saying that sophisticated activist bondholders budgeted for bankruptcy bonuses when they made their investments in the firm’s debt. Ann Davis, *Want Some Extra Cash? File for Chapter 11*, WALL ST. J., Oct. 31, 2001, at C1 (discussing the rise in popularity of Chapter 11 bonuses and the changing views among creditors). By keeping them at their desks with retention payments, creditors retain value in the firm that would otherwise be lost if they were to quit. Yair Listkoin criticizes retention payments for not being more closely related to positive bankruptcy outcomes. Yair Listkoin, *Paying for Performance in Bankruptcy: Why CEOs Should Be Compensated with Debt*, 155 U. PA. L. REV. 777, 790 (2007) (summarizing arguments against “pay to stay” compensation). Robert Rasmussen makes an argument that Congress erred by eliminating retention bonuses because they usefully provided creditors—the new owners—with a real option regarding the debtor’s workers. That is to say, by retaining employees long enough to evaluate them, retention bonuses serve the useful purpose of allowing creditors or new managers to decide who to keep. See Robert K. Rasmussen, *On the Scope of Managerial Discretion in Chapter 11*, 156 U. PA. L. REV. PENUMBRA 77, 80–85 (2007).

13. Sandra E. Mayerson & Chirstalette Hoey, *Employee Issues from Pre-Petition Severance to Post-Petition Defaulted Pension Plans; and Standards for Permitting Senior Management Bonuses*,

Chapter 11 debtors offered two main justifications for why they needed to pay retention bonuses. First, they usually pointed to the value that the debtor's current employees contribute to the restructuring effort.¹⁴ Incumbent employees often have firm-specific knowledge that would be costly to lose and hard to replicate in new employees.¹⁵ Even if the knowledge could be replicated, Chapter 11 debtors may fear that they will have trouble attracting new employees because new hires might hesitate before accepting a job with a bankrupt company.¹⁶

Second, many debtors claimed that they needed to update their compensation practices to avoid underpaying employees.¹⁷ This underpayment problem arose because of the growing complexity of executive pay packages.¹⁸ At a high level, executive compensation consists of two components: (1) a "base" payment, (2) and a "bonus" payment. The base payment is what we usually think of as salary; the amount of money that a manager expects to be paid for showing up to work every day.¹⁹ The bonus payment is a catchall term that consists of all performance-related pay, such as rewards for achieving a sales goal or remaining an employee

092002 AM. BANKR. INST. 409 (2002).

14. See, e.g., *In re Aerovox, Inc.*, 269 B.R. 74, 76 (Bankr. D. Mass. 2001).

The Debtor summarized the incentives it designed as follows: 1) to keep the eligible employees, including the Key Employees, in the Debtors employ; 2) to compensate the eligible employees, including the Key Employees, for assuming "additional administrative and operational burdens imposed on the Debtor by its Chapter 11 case;" and 3) to allow the eligible employees, including the Key Employees, to use "their best efforts to ensure the maximization of estate assets for the benefits of creditors."

Id. (internal citations omitted).

15. *Id.* at 79.

Moreover, in the Board's view, replacing the Key Employees would cause the Debtor to incur significant costs. Mr. Horsley testified that the process of replacing any one of the Key Employees could cost up to one years' salary in order to cover the cost of a headhunter and other recruitment expenses. He added that, even if the Debtor were to find qualified replacements, it would not be able to quickly get these new employees "up to speed." This cost-benefit analysis weighed heavily into the Board's ultimate decision.

Id.

16. See *id.*

17. In the face of intense criticism, firms began to change their compensation practices to try to align pay with performance. See, e.g., Jensen & Murphy, *supra* note 9.

18. See Brian J. Hall & Jeffrey B. Liebman, *Are CEOs Really Paid Like Bureaucrats?*, 113 Q.J. ECON. 653, 661–63 (1998) (finding that most of the pay increase for chief executive officers between 1980 and 1994 was in the form of stock options, which increased the percentage of a firm's total compensation package weighted towards performance compensation).

19. See Kevin J. Murphy, *Executive Compensation*, in 3B HANDBOOK OF LABOR ECONOMICS 2485, 2491 (Orley Ashenfeller & David Card eds., 1999) ("[M]ost executive pay packages contain four basic components: a base salary, an annual bonus tied to accounting performance, stock options, and longterm incentive plans (including restricted stock plans and multi-year accounting-based performance plans)."). Stock compensation includes both outright grants of stock as well as restricted stock and stock options.

of the firm for a certain period of time.²⁰ Increasingly, in the early 1990s, large firms began to rely on bonus compensation, creating new pressure to update performance-compensation policies to reflect changes in the firm's business and the disruption created by bankruptcy.²¹ Accordingly, Chapter 11 debtors argued that they needed to pay retention bonuses to avoid paying valuable employees significantly less money than they were accustomed to making, undermining morale and retention.²²

20. The compensation consulting firm Equilar reported that in 2013, 63.8% of S&P 1500 companies used some form of performance-based equity compensation, 82.8% used short-term cash incentives, 15% had a discretionary cash bonus, and 8.3% had a long-term incentive plan tied to multiyear performance goals. EQUILAR, CEO PAY STRATEGIES REPORT 4-5 (2014), <https://www2.deloitte.com/content/dam/Deloitte/us/Documents/regulatory/us-aers-ceo-pay-strategies-report-2014-equilar-july-2014-020915.pdf>. While Equilar does not aggregate these numbers, it is fair to assume that virtually all large firms use bonus compensation. The pre-bankruptcy use of stock compensation can be in and of itself sufficient to require a new compensation policy, as Chapter 11 usually ends with pre-bankruptcy shareholders receiving no recovery. See generally Notice of Filing of Amended Disclosure Statement for Debtors' Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankr. Code, *In re Hawker Beechcraft, Inc.*, 486 B.R. 264 (Bankr. S.D.N.Y. 2013) (No. 12-11873) [hereinafter *Hawker Beechcraft Disclosure*].

21. See Hall & Liebman, *supra* note 18. Firms have two alternatives to adjusting compensation policy in bankruptcy, but they are unattractive, for different reasons. One option is to adjust management's compensation pre-bankruptcy by giving them large base salaries, which effectively reweights their compensation away from bonus and towards base. Doing so creates important risks for a firm, as news of bonus payments can disrupt negotiations with creditors and create liability for the executive who might find the payment clawed back as a fraudulent conveyance. Alternatively, the firm can avoid adjusting compensation until after bankruptcy, which creates the risk that managers might leave the firm rather than wait for an uncertain payment. See James Sprayregen et al., *Recent Lessons on Management Compensation at Various Stages of the Chapter 11 Process*, FINANCIER WORLDWIDE (Mar. 2013), <https://www.financierworldwide.com/recent-lessons-on-management-compensation-at-various-stages-of-the-chapter-11-process/#.XEZb6S3Myu4>.

22. See, e.g., Mitchell A. Seider et al., *Two Recent Decisions Highlight Pitfalls in Creating and Implementing Key Employee Incentive Plans for Executives in Bankruptcy Cases*, LATHAM & WATKINS: CLIENT ALERT (Sept. 24, 2012), <https://www.lw.com/thoughtLeadership/employee-incentive-plans-executives-bankruptcy> ("[I]t may be difficult to replicate . . . employees' pre-petition compensation during the Chapter 11 case because a significant part of their compensation may have been in the form of stock options (which are likely worthless in light of the bankruptcy proceedings) and performance bonuses based on metrics that are no longer achievable. Furthermore, these employees may seriously consider other employment opportunities that do not involve the risks inherent in working for a company in Chapter 11."); Notice of (1) Filing of the Solicitation Version of the Amended Disclosure Statement for the Debtors' Solicitation Version of the Amended Joint Plan of Reorganization Pursuant to Chapter 11 of the Bankruptcy Code and (2) Deadline for Parties to Object Thereto, *In re Hawker Beechcraft, Inc.*, 486 B.R. 264 (Bankr. S.D.N.Y. 2013) (No. 12-11873) ("[C]urrent compensation levels for each of the KERP Participants are below market levels largely because no MIP or Equity Investment Plan bonuses have been paid in recent years and also due to a decrease in earned commissions. The Debtors believe the KERP will aid the Debtors' retention of the KERP Participants and will incentivize them to expend the additional efforts and time necessary to maximize the value of the Debtors' assets.").

B. AS THE ECONOMY FELL INTO RECESSION IN THE EARLY 2000S, THE
PUBLIC SALIENCE AND CONTROVERSY OVER CHAPTER 11 BONUSES
INCREASED

These retention bonus plans became the subject of controversy in the early 2000's for three main reasons. First, the public spectacle of a failed firm paying millions of dollars in bonuses to senior managers while firing workers naturally led to populist outrage.²³ The controversy over bankruptcy-related pay echoed the still-raging public controversy over the high levels of executive pay, which seemed unfair to many observers and was especially salient after the dot-com bust sent the nation into recession.²⁴

Second, the bonuses attracted criticism from some commentators who worried that the public nature of the payments and the large amount of media attention that they attracted were undermining public confidence in the bankruptcy process.²⁵

Third—and most importantly from the perspective of bankruptcy policy—some observers believed that management was exploiting the basic structure of Chapter 11 to extract undeserved pay.²⁶ When a firm files for bankruptcy, existing management remains in control of the business, giving managers great influence over the firm and its stakeholders.²⁷

23. See, e.g., Nancy Rivera Brooks, *Enron Execs Were Paid to Remain*, L.A. TIMES (Dec. 7, 2001), <http://articles.latimes.com/2001/dec/07/business/fi-12293>.

24. See, e.g., Henry, *supra* note 3 (detailing executive retention plans paid out in high-profile Chapter 11 bankruptcy cases).

25. At the 2003 Annual Spring Conference of the American Bankruptcy Institute, a lawyer arguing against allowing KERPs worried very much that the failure to curb bankruptcy bonus abuse (in the form of the Key Employee Retention Plans that had become a routine part of bankruptcy practice) would result in congressional intervention. See *Critical Vendor Motions, Retention Bonuses Headed for Endangered List*, 39 BANKR. CT. DECISIONS: WKLY. NEWS & COMMENT 1 (Aug. 13, 2002); see also Keach, *supra* note 3.

26. See M. Todd Henderson, *Paying CEOs in Bankruptcy: Executive Compensation When Agency Costs Are Low*, 101 NW. U. L. REV. 1543, 1543–44, 1570 (2007) (“According to [academic accounts of bankruptcy], the Bankruptcy Code’s preference for management operation of the debtor allows managers to extract rents in the form of higher salaries, big option grants, and lavish retention and emergence bonuses.”); Lynn M. LoPucki & William C. Whitford, *Corporate Governance in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 141 U. PA. L. REV. 669, 740 (1993) (“In the course of our study, we became suspicious that some CEOs were using leverage generated from the power vested in the debtor-in-possession by the Bankruptcy Code to negotiate increases in their personal compensation.”); Lucien Ayre Bebchuk & Howard F. Chang, *Bargaining and the Division of Value in Corporate Reorganization*, 8 J.L. ECON. & ORG. 253, 267 n.14 (1992) (“In reality, the incumbent management controls the agenda during this initial period [of Chapter 11 Bankruptcy].”).

27. Alan Schwartz, *A Contract Theory Approach to Business Bankruptcy*, 107 YALE L.J. 1807, 1836 (1998) (noting Chapter 11 is preferable to Chapter 7 for current management, in terms of ability to manipulate the process for personal gain); see also Henderson, *supra* note 26, at 1574 (noting a

Management's control over the bankruptcy process can lead the board of directors and even creditors to seek to pay managers for desired outcomes, such as enticing management to agree to sell the firm.²⁸ The dislocations created by bankruptcy can also provide management with bargaining power.²⁹ The board of directors may fear that the departure of a key executive would seriously reduce the prospect of a successful reorganization, creating an opportunity for opportunistic managers to demand more pay than they deserve.³⁰ This agency problem threatens the basic structure of Chapter 11 bankruptcy, a process in which a firm's asset value is supposed to be maximized for the benefit of pre-bankruptcy creditors, not the personal wealth of incumbent managers.

Of course, the Bankruptcy Code recognizes the power that management has over a corporation in bankruptcy and thus creates a strong system of checks and balances to counterbalance managerial power.³¹ The first line of defense is the federal bankruptcy judge, who must approve any payment of bonuses.³² Next, bankruptcy law appoints an "[o]fficial [c]ommittee of [u]nsecured [c]reditors" to act as a "watchdog" that scrutinizes management's business decisions.³³ This committee is generally composed of some of the firm's major creditors, who stand to receive lower

potential factor favoring management in Chapter 11 is "the possibility that creditors will tolerate inefficient or unfair compensation to curry favor with CEOs, since the debtor has the exclusive right to propose a reorganization plan"; LoPucki & Whitford, *supra* note 26, at 692 ("[M]anagement of the debtor corporation routinely remains in office after [the bankruptcy] filing and has considerable power over both the business plan and the reorganization plan.").

28. One student researcher interviewed legendary bankruptcy attorney Harvey Miller in 2005 and reported:

Eventually, according to Miller, the negotiations come to point where the controlling distressed investors tell the CEO, "if you want to be CEO of the company, don't fight us—because if you fight and we win, you're dead." According to Miller, some management teams will eventually give in, often after the distressed investors have agreed to provide them with post-emergence employment contracts.

Paul M. Goldschmid, Note, *More Phoenix Than Vulture: The Case for Distressed Investor Presence in the Bankruptcy Reorganization Process*, 2005 COLUM. BUS. L. REV. 191, 266–67 (2005).

29. See Henderson, *supra* note 26, at 1575–76 (2007) ("Thus, given the firm's poor performance, whether or not it can be deemed to be the CEO's fault, the firm should be able to pay the CEO less, but the costs of the next best alternative are so much higher that the CEO is actually in a stronger negotiating position.").

30. See LoPucki & Whitford, *supra* note 26, at 742 ("[I]n some reorganization cases management derives considerable power from their incumbency.").

31. See *id.* at 694–720 (describing the checks on management).

32. *In re Salant Corp.*, 176 B.R. 131, 132 (S.D.N.Y. 1994) ("The Bankruptcy Court approved the bonus to [the CEO] at the confirmation hearing . . ."); see also *In re Velo Holdings Inc.*, 472 B.R. 201, 204 (Bankr. S.D.N.Y. 2012) (approving KERP during bankruptcy case).

33. See, e.g., *In re W. Pac. Airlines, Inc.*, 219 B.R. 575, 578 (D. Colo. 1998) ("[A] creditors committee serves something of a 'watchdog' function in bankruptcy and enjoys unique rights and responsibilities under the Code.").

payouts at the end of the bankruptcy case if the firm overpays management.³⁴ The committee will usually have a high-powered law firm and investment bank assisting them, and they will analyze any proposed bonus plan to determine whether it overpays managers.³⁵ To the extent that creditors believe management is extracting undeserved pay, they can file written objections informing the judge of the bonus plan's problems and negotiate in the shadow of those objections and the right to object.³⁶

Further, the Department of Justice's United States Trustee Program provides a second level of governmental oversight that helps the bankruptcy judge assess the motions in front of her.³⁷ Congress created the United States Trustee Program as a part of the Bankruptcy Act of 1978 to oversee the then-new system of bankruptcy courts.³⁸ Each district has its own Office of the United States Trustee, which generally consists of several attorneys and other legal professionals.³⁹ These lawyers supervise all bankruptcy cases, looking for evidence that bankruptcy law is being abused.⁴⁰ The United States Trustee has the right to file an objection of its own if it determines that management is using its control of the corporation to extract excessive compensation.⁴¹

Prior to the 2005 reform, this system of checks and balances lay

34. Wei Jiang et al., *Hedge Funds and Chapter 11*, 67 J. FIN. 513, 527 n.10 (2012).

35. See generally Jared A. Ellias, *Do Activist Investors Constrain Managerial Moral Hazard in Chapter 11?: Evidence from Junior Activist Investing*, 8 J. LEGAL ANALYSIS 493 (2016) (finding activist investors actually reduce self-dealing and promote the goals of bankruptcy); Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations*, 64 VAND. L. REV. 749 (2011) (providing data on the impact of creditors on bankruptcy proceedings).

36. See Ellias, *supra* note 35, at 495 ("In Chapter 11, managers must obtain judicial approval for all major business decisions . . . [creditors] may inform the judge that management is abusing Chapter 11 and file motions seeking judicial relief.").

37. See Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 AM. BANKR. INST. L. REV. 5, 35 (1995). ("In 1986 the United States Trustee system was established nationwide An attempt was made to relieve bankruptcy judges of administrative duties, thereby permitting them to focus more exclusively on their judicial role.").

38. See *id.*

39. *About the Program: The United States Trustee Program*, U.S. DEP'T JUST., <https://www.justice.gov/ust/about-program> (last updated Mar. 6, 2019).

40. *Id.*

41. See Objection of the U.S. Trustee to Debtors' Motion Pursuant to Section 363(b) of the Bankr. Code for Authorization to Implement a Key Emp. Incentive Plan at 9, *In re BearingPoint, Inc.*, 453 B.R. 486 (Bankr. S.D.N.Y. 2011) (No. 09-10691) [hereinafter *BearingPoint Objection*].

The Motion is not supported by any indication that the costs of the KEIP are reasonable under the circumstances. To the contrary, the currently-prevailing view here appears to be that such proceeds will be insufficient to generate a recovery for unsecured creditors. Also, there is no basis on which to conclude that the \$7.0 million cost of the Debtors' revised bonus plan is reasonable

Id.

dormant because bankruptcy law instructed the judge to defer to management in determining if bonuses were needed.⁴² Chapter 11 debtors only needed to convince the judge that a proposed retention bonus plan was the product of reasonable business judgment.⁴³ This was an easy standard to satisfy, and firms would do so by arguing that the employees were important to the successful reorganization of the business⁴⁴ and that the board of directors engaged in some sort of deliberative process to develop the plan.⁴⁵

C. CONGRESS EMPOWERS THE OVERSIGHT OF MANAGERS AND RESTRICTS RETENTION BONUSES WITH THE 2005 REFORM

This equilibrium changed when Congress banned retention bonuses as part of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "BAPCPA").⁴⁶ Congress sought to "eradicate the notion that executives were entitled to bonuses simply for staying with the Company through the bankruptcy process."⁴⁷ After the reform, bankruptcy judges

42. That's not to say that judges did not sometimes reject bonus plans. *Levitz Judge Rejects Bankruptcy Bonus, Limits Severance Package*, 2 ANDREWS BANKR. LITIG. REP. 7 (2005) (discussing Judge Burton Lifland's rejection of a proposed retention bonus in the Levitz Homes bankruptcy when the company had mostly outsourced operation of its business to consultants).

43. See *In re Montgomery Ward Holding Corp.*, 242 B.R. 147, 155 (D. Del. 1999) (noting the discretion the bankruptcy court has to defer to management's business judgment in approving bankruptcy bonus plans). Bankruptcy courts approved executive bonuses upon a showing by the debtor that: (i) the debtor used proper business judgment in creating the plan, and (ii) the plan is "fair and reasonable." Emily Watson Haring, *Walking and Talking like a KERP: Implications of BAPCPA Section 503(c) for Effective Leadership at Troubled Companies*, 2008 U. ILL. L. REV. 1285, 1293 (2008); see also George W. Kuney, *Hijacking Chapter 11*, 21 EMORY BANKR. DEV. J. 19, 78–80 (2004) (summarizing the standard in pre-BAPCA cases). Kuney notes that this standard was either considered overly permissive or unnecessarily restrictive, depending on the particular biases of the critic. *Id.* at 80; accord Cornwell, *supra* note 4, at 493–94 (summarizing the pre-BAPCA standard).

44. *In re Brooklyn Hosp. Ctr.*, 341 B.R. 405, 409 (Bankr. E.D.N.Y. 2006); see also *In re Aerovox, Inc.*, 269 B.R. 74, 79 (Bankr. D. Mass. 2001) (discussing the importance of the employees to the turnaround effort).

45. See *Brooklyn Hosp. Ctr.*, 341 B.R. at 412 (discussing the deliberations of the Board); see also *In re Georgetown Steel Co.*, 306 B.R. 549, 554 (Bankr. D.S.C. 2004) ("The CEO described the deliberations of the Board of Directors with respect to the Retention Motion as well as the processes utilized to arrive at the final amount of the Retention Plan."); *Aerovox*, 269 B.R. at 81–82 ("[T]he Board utilized sound business judgment in evaluating the need for and financial implications of the KERP. . . . [T]he Board met five times before approving the original KERP."); Dickerson, *supra* note 12, at 97–103.

46. See Paul R. Hage, *Key Employee Retention Plans under BAPCPA? Is There Anything Left?*, 17 J. BANKR. L. & PRAC. 1, 15 (2008) ("[S]ection 503(c) prohibits payments to an insider 'for the purpose of inducing such person to remain with the debtor's business.'"). The BAPCPA mostly affected consumer bankruptcy, and the reform studied in this Article was one of the handful of provisions that altered business bankruptcy in a significant way.

47. *In re Global Home Prods., L.L.C.*, 369 B.R. 778, 783–84 (Bankr. D. Del. 2007) (quoting Karen Lee Turner & Ronald S. Gellert, *Dana Hits a Roadblock: Why Post-BAPCPA Laws May Impose*

were only allowed to authorize Chapter 11 debtors to pay “incentive” bonuses, typically through a formal “Key Employee Incentive Plan” (“KEIP”).⁴⁸ In theory, KEIPs tie any bonus payments to the achievement of challenging performance goals, such as improving the firm’s financial performance or attaining a milestone in the bankruptcy process like confirming a plan of reorganization.⁴⁹ As a result, bankruptcy judges found themselves with the challenging new task of evaluating proposed bonus plans to determine if they were permissible incentive plans or “disguised retention plans” that did not actually challenge management.⁵⁰

Consider a hypothetical bonus plan that pays an executive if the firm’s revenue increases by 10 percent. Is this an incentive plan or a retention plan? The answer turns on how likely it is for that anticipated revenue increase to occur.⁵¹ An executive who commits to such a plan may very well have private information regarding an imminent sale to a major

Stricter KERP Standards, 3 BANKR. LITIG. REP. 2, 2 (2006)); see also Edward E. Neiger, *Bankruptcy Courts Continue to Approve Performance-Based Bonuses for Executives of Companies in Chapter 11*, 3 PRATT’S J. BANKR. L. 356, 357 (2007).

48. See 11 U.S.C. § 503 (2018); *In re Dana Corp.*, 358 B.R. 567, 575–78 (summarizing the changes to the Bankruptcy Code); Skeel, *supra* note 12, at 928 (describing KEIPs). In sample cases, it is very clear that—in at least some instances—the KEIP was designed more with a view to what the court would approve than what actually needed to provide incentive compensation to senior executives. For example, in the bankruptcy of Nortel, the debtor’s compensation consultant examined other recent KEIPs and provided its senior managers with a maximum number of how much money could be distributed in bonuses and how many people could be paid, and this was used to generate an incentive plan. See Declaration of John Dempsey in Support Debtors’ Motion for an Order Seeking Approval of Key Emp. Retention Plan and Key Exec. Incentive Plan, and Certain Other Related Relief at 5, *In re Nortel Networks Inc.*, 426 B.R. 84 (Bankr. D. Del. Feb. 27, 2009) (No. 09-10138) [hereinafter Dempsey Declaration].

In determining the appropriate number of employees eligible, maximum program cost, and the size of awards to be granted, I reviewed Key Employee Incentive Plans that had been approved by bankruptcy courts in a number of recent chapter 11 cases. The companies for which these plans were approved reflect entities both inside and outside the technology sector as well as companies facing multi-jurisdictional issues, including SemGroup LLP, Quebecor World, Delphi Corporation, Dura Automotive, and Calpine Corporation.

Id. In Dempsey’s defense, Nortel was a large firm and the compared firms, albeit engaged in entirely different lines of business and headquartered in different cities, were also large firms. Nonetheless, the selection of compared firms is curious. In terms of the number of managers, he testified, “I advised Nortel management to select participants that would result in a population of employees totaling approximately 5% of the aggregate Nortel population, as this amount was well within the range of competitive market practice.” *Id.*

49. See Skeel, *supra* note 12, at 928 (“[C]reditors have insisted in recent cases that the managers’ compensation be tied to the company’s progress under Chapter 11. The most straightforward strategy for rewarding managers who handle the case expeditiously is to base their compensation, at least in part, on the speed of the reorganization.”).

50. See Hage, *supra* note 46, at 22–27 (discussing the early decisions); see also Revich, *supra* note 4, at 94.

51. See *In re Velo Holdings Inc.*, 472 B.R. 201, 211 (Bankr. S.D.N.Y. 2012) (analyzing a proposed KEIP plan to insure the targets are “difficult to achieve”).

customer that will yield the 10 percent increase, making the incentive plan a “disguised retention plan” that rewards the manager for remaining employed without requiring extra effort and accomplishment to earn the bonus.⁵² On the other hand, in some cases a 10 percent increase in revenue could be highly unlikely and something management can only achieve with extra effort.⁵³ How can one proposed bonus plan be distinguished from another? In the seminal case interpreting the 2005 reform, Judge Burton I. Lifland of the Southern District of New York declared “if it walks like a duck (KERP) and quacks like a duck (KERP), it’s a duck (KERP).”⁵⁴

Judge Lifland also identified several factors that bankruptcy courts should analyze to determine if a proposed bonus plan creates challenging incentive bonuses or disguised retention bonuses:

Is there a reasonable relationship between the plan proposed and the results to be obtained, i.e., will the key employee stay for as long as it takes for the debtor to reorganize or market its assets, or, in the case of a performance incentive, *is the plan calculated to achieve the desired performance?*

Is the cost of the plan reasonable in the context of the debtor’s assets, liabilities and earning potential?

Is the scope of the plan fair and reasonable; does it apply to all employees; does it discriminate unfairly?

Is the plan or proposal consistent with industry standards?

What were the due diligence efforts of the debtor in investigating the need for a plan; analyzing which key employees need to be incentivized; what is available; what is generally applicable in a particular industry?

Did the debtor receive independent counsel in performing due diligence and in creating and authorizing the incentive compensation?⁵⁵

To summarize, the 2005 reform is best understood as creating new responsibilities for Chapter 11 debtors, the bankruptcy judges, and the Department of Justice’s United States Trustee Program, while providing new bargaining power for creditors. Prior to the reform, a Chapter 11 debtor could easily obtain a judge’s permission to pay bonuses by demonstrating a plausible business justification.⁵⁶ After the reform, Chapter

52. See LoPucki & Whitford, *supra* note 26, at 694 (“Management also gains considerable power by being better informed than other interested parties.”).

53. Of course, in some cases a 10% revenue increase can result from changed market conditions or political developments that improve the firm’s prospects with no increased effort from managers.

54. *In re Dana Corp.*, 351 B.R. 96, 102 n.3 (Bankr. S.D.N.Y. 2006).

55. *In re Dana Corp.*, 358 B.R. 567, 576–77 (Bankr. S.D.N.Y. 2006) (emphasis in original) (internal citations omitted).

56. See Revich, *supra* note 4, at 116.

11 debtors can only pay bonuses if they convince a judge that a proposed bonus plan requires management to demonstrate extra effort and skill. The standard developed in the *Dana Corp.*, and re-articulated above, requires the debtor to present evidence of industry and firm practices to demonstrate the reasonableness of the overall level of compensation, as well as the structure that would trigger the payment of bonuses. In making this case, Chapter 11 debtors typically present the testimony of an independent compensation consultant that helped to develop the incentive plan. The judge then must weigh significantly more evidence and make more findings of fact than was the case prior to the 2005 reform. This new bargaining dynamic empowers creditors, who can investigate a proposed bonus plan, file an objection, and negotiate to change the plan in the shadow of the objection.⁵⁷

II. THEORETICAL PROBLEMS WITH THE 2005 REFORM

This Part describes theoretical flaws that undermine the bankruptcy system's then-newfound mandate to police executive compensation in bankruptcy. These flaws lead to three testable hypotheses about the reform, which are respectively analyzed using empirical evidence in Section III.B.

As a general rule, laws that leave gaps create incentives for regulatory evasion.⁵⁸ The 2005 reform only affects bonuses paid through court-approved bonus plans in Chapter 11. This narrow scope allows firms to simply sidestep the regulation by paying managers prior to filing for bankruptcy or waiting until a Chapter 11 case ends to adjust management's compensation retroactively. Indeed, the reform likely created financial incentives for firms to engage in evasion, as the additional work that law firms need to do to meet the new standard is costly.

Accordingly, hypothesis one is that firms will respond to the increased costs of proposing a bankruptcy bonus plan by evading the new regulation and paying managers through channels unaffected by the 2005 reform.⁵⁹

Further, the reform places bankruptcy judges in the challenging position of distinguishing permissible incentive plans from forbidden retention plans. To do so, judges must assess *ex ante* the likelihood that a triggering event will occur. If a performance goal is likely to occur without additional managerial effort, the judge should reject it as a disguised

57. See Bharath et al., *supra* note 10, at 24 (suggesting the use of KERPs contribute to more equitable Chapter 11 outcomes, as measured by the frequency of Absolute Priority Deviations).

58. See, e.g., Victor Fleischer, *Regulatory Arbitrage*, 89 TEX. L. REV. 227, 278–80 (2010).

59. For evidence supporting this hypothesis surveyed, see generally *infra* Section III.B.1.

retention plan that rewards management for remaining employed. This is a difficult analysis. The boards of directors and managers that develop bonus plans presumably know their businesses better than the judge, placing the judge at a disadvantage in evaluating a bonus plan. Further, judges are bankruptcy lawyers and lack subject-matter expertise in executive compensation, let alone specific knowledge of the firm's industry. Moreover, even in a world with perfect information, the judge would still struggle to perform this analysis because the line between retention and incentive plans is very thin. All incentive plans have some retentive element, as employees often remain in jobs to earn promised bonuses.⁶⁰

Therefore, hypothesis two is that bankruptcy judges are unlikely to be able to screen out all but the most obviously disguised retention plans, and the bonus plans that are approved are unlikely to be significantly different in substance than the bonus plans prior to the reform.⁶¹

The challenges that bankruptcy judges face are exacerbated by the incentives that creditors have to use their bargaining power to police executive compensation.⁶² One of the main reasons that executive compensation theorists have long sought to empower investors with a greater voice in determining executive pay is because of the belief that the excess compensation paid to managers reduces the returns to investors.⁶³ Superficially, this is the case in Chapter 11 as well, as creditors are generally the firm's residual claimant and thus the losers if the firm overpays management. However, executive bonuses affect such a small amount of value in large Chapter 11 cases—single-digit millions when the firm's assets can potentially be worth billions—that we would expect creditors might decline to spend the time and money required to actively police executive compensation.

Further, the bankruptcy judge is unlikely to get much help from the Department of Justice's U.S. Trustee Program. In theory, the Department of Justice only has incentives to enforce bankruptcy law, and the 2005 reform created a new Congressional policy of policing abuses in executive

60. See Margaret Howard, *The Law of Unintended Consequences*, 31 S. ILL. U. L.J. 451, 456 (2007); Allison K. Verderber Herriott, *Toward an Understanding of the Dialectical Tensions Inherent in CEO and Key Employee Retention Plans During Bankruptcy*, 98 NW. U. L. REV. 579, 615 (2004); Revich, *supra* note 4, at 112 (considering Judge Lifland's decision in *In re Dana Corp.*, which noted permissible incentive plans may have retentive effects).

61. For evidence supporting this hypothesis surveyed, see *infra* Section III.B.2.

62. Economic theory has long held that people respond to incentives. *E.g.*, Gary S. Becker, *Irrational Behavior and Economic Theory*, 70 J. POL. ECON. 1, 9 (1962).

63. Karen Dillon, *The Coming Battle over Executive Pay*, HARV. BUS. REV. (2009), <https://hbr.org/2009/09/the-coming-battle-over-executive-pay>.

compensation. In practice, the U.S. Trustee suffers from the same informational asymmetries and expertise deficits that limit a judge's effectiveness in evaluating a proposed bonus plan. The 2005 reform did not provide extra money to hire compensation experts to help the lawyers in the U.S. Trustee's office analyze proposed bonus plans.

Accordingly, hypothesis three is that the bankruptcy judges are unlikely to receive much help from creditors and the U.S. Trustee. Creditors have weak incentives, on average, to invest the time and resources required to police executive compensation aggressively. The U.S. Trustee lacks the necessary expertise to perform the role assigned to it by Congress.⁶⁴

III. EVIDENCE OF DESIGN PROBLEMS IN THE 2005 REFORM

Part III presents an account of the flaws that undermine the 2005 reform. Section III.A first describe the data gathering methodology and the sample of bankruptcy cases. In Section III.B, evidence from the empirical study tests the hypotheses developed in Part II.

A. SAMPLE AND DATA GATHERING

To study the reform, I gathered two samples of data: (1) a large sample that represents the population of large companies that filed for Chapter 11 between 2001 and 2012 with traded debt or equity and (2) a smaller case study sample of cases from before and after the statutory change to examine bonus plans (and bankruptcy litigation) in a more comprehensive and detailed way. Both samples are drawn from Next Generation Research's list of large company bankruptcies from 2001 to 2012.⁶⁵ I describe the construction of the large sample and the case study sample in turn.

The large sample consists of all large companies from Next Generation Research's list of large company bankruptcies from 2001 to 2012 that traded debt or equity. I focus on firms with publicly traded debt or equity because those firms have obligations to file disclosures with the Securities and Exchange Commission ("SEC"), so information on firm compensation practices are available. Nearly all of the largest firms to file

64. For evidence supporting this hypothesis surveyed, see *infra* Section III.B.3.

65. See generally *Data & Research*, BANKR. DATA, <http://bankruptcydata.com/p/data-research> (last visited Apr. 8, 2019). Next Generation Research's Bankruptcy Data service is a commonly used data source for empirical bankruptcy studies. *Accord*, e.g., Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. LEGAL ANALYSIS 511, 517 (2009).

for bankruptcy have traded debt or equity, and this larger sample is very close to the population of large companies that restructured their debt in Chapter 11 court proceedings between January 1, 2001 and December 31, 2012.

I identified the firms included in the larger sample through the following procedure.⁶⁶ For each of the 1,998 large firms that filed for Chapter 11 bankruptcy between 2001 and 2012, I looked for matches in the list of debt or equity issued by large firms that traded in the databases kept by TRACE, MarkIt, and Bloomberg.⁶⁷ For example, if I found that a firm filed for bankruptcy on January 3, 2003, I looked for trades in that firm's debt or equity entered on or after that date. This larger sample consists of 408 cases. For each of the firms in the sample, I collected extensive information about the firm and the bankruptcy case from the court docket and important pleadings. Most importantly, I recorded whether the firm sought judicial approval of a bankruptcy bonus plan and identified which, if any, bonus plans were approved by the bankruptcy judge. For all of these firms, I also examined their securities filings to obtain additional information on how the firm historically compensated its executives.⁶⁸

I collected the case study sample using a similar method. I again began with the list of all firms listed in Next Generation Research's database of corporate bankruptcies, including those without traded debt or equity.⁶⁹ The case study sample comes from two time periods. First, I collected a "before" sample of every large bankruptcy case from Next

66. A portion of this larger sample was used previously in Jared A. Elias, *What Drives Bankruptcy Forum Shopping? Evidence from Market Data*, 47 J. LEGAL STUD. 119, 124–26 (2018). I provide greater detail regarding construction of the larger sample. While this Article shares basic information on bankruptcy cases with that larger dataset, the data on executive compensation presented here were collected specifically for this project and are unique and new.

67. "TRACE" is a complete record of all buying and selling of corporate bonds, with transaction-level data on all trades during the sample period. It is the standard source for bond data in empirical finance literature. "MarkIt" is a data provider that compiles trading in corporate loans. Bloomberg maintains records in trading of both listed and over-the-counter equity. I do not report results using TRACE, MarkIt, or Bloomberg data in this Article.

68. Firms generally disclose executive compensation as part of their annual report or proxy statements for their annual meeting. See *Fast Answers: Executive Compensation*, U.S. SEC. & EXCHANGE COMM'N, <https://www.sec.gov/fast-answers/answers-excomp.htm> (last visited Apr. 8, 2019) ("The easiest place to look up information on executive pay is probably the annual proxy statement. Annual reports on Form 10-K and registration statements might simply refer you to the information in the annual proxy statement, rather than presenting the information directly.").

69. This means that the case study sample is drawn from a slightly broader universe than the larger sample, which is restricted to public firms with traded claims. I do not believe this introduces bias into the analysis, and it avoids any bias that could result from looking only at public firms. The results presented below are the same if I restrict the case study sample to the universe of firms with traded claims.

Generation Research's list of large corporate bankruptcies that filed between January 1, 2004 and April 20, 2005, the date that BAPCPA was signed into law by President George W. Bush. I begin with January 1, 2004, because older dockets are generally no longer available on the Public Access to Court Electronic Records database ("PACER"). The initial sample consisted of 140 potential Chapter 11 debtors, of which forty-one (approximately 30%) sought judicial approval for a key employee retention or incentive plan. These forty-one Chapter 11 debtors constitute the pre-BAPCPA sample, which I term the "pre-reform" or "pre-2005 reform" sample.

The second case study sample period consists of all firms that filed for Chapter 11 bankruptcy between January 1, 2009 and December 31, 2010 that implemented bankruptcy bonus plans. I choose a period four years after the reform because it took several court decisions to settle on a legal standard for adjudicating proposed post-reform incentive plans and lawyers needed time to develop customs to meet that standard.⁷⁰ I began with the list of 375 large bankruptcy cases and examined each court docket to look for a proposed bonus plan. The final sample consists of fifty-seven bonus plans filed by debtors that filed for bankruptcy in 2009 and 2010.⁷¹

I studied each case in the case study sample very closely. In addition to examining the docket and acquiring basic information from court filings, I examined all objections filed by creditors and the United States Trustee to managements' motions seeking approval of bonus plans. I also compared the bonus plans approved by the court to the original bonus plans to track changes made over the course of the bargaining process. Next, I examined the goals created by the plans and used the date of bankruptcy events, the disclosure statement and subsequent securities disclosures, news stories, and press releases to determine whether management achieved the incentive payout.

Finally, I examined all of the legal bills filed by the debtor's counsel for the period between the petition date and the bonus plan being approved by the court. When large firms are in Chapter 11 bankruptcy, they ask for (and receive) a court order allowing them to retain a law firm to help them

70. *In re Dana Corp.*, 358 B.R. 567, 576–77 (Bankr. S.D.N.Y. 2006) (emphasis in original). (internal citations omitted); see also *supra* note 55 and accompanying text.

71. One possible complaint about my methodology is that the 2009 and 2010 "post-reform" sample includes the bankruptcy cases that resulted from the financial crisis. The broad conclusions from the study come from the larger sample. The case study sample is used mostly to illustrate problems with the reform, provide institutional detail, and estimate the increase in costs, which should not be affected by the financial crisis and its aftermath.

with their bankruptcy.⁷² The Chapter 11 debtor then submits its law firm's legal bills to the court and asks for permission to pay them.⁷³ The Federal Rules of Bankruptcy Procedure require a detailed statement of the time the attorneys spent on the firm's legal problems, which in practice translates to the full record of all time charged to the client. I oversaw a team of research assistants that worked together to identify the amount and value of time that law firms spent on bonus plans for both time periods in the case study sample. I provide an illustrative example of this analysis in the Appendix. To my knowledge, this is a new method in the bankruptcy practice literature, and a very labor-intensive one, but it holds significant promise in terms of aiding our understanding of bankruptcy costs.

B. ASSESSING EVIDENCE OF DESIGN FLAWS IN THE 2005 REFORM

The 2005 reform aimed to reduce public outrage over bankruptcy bonuses, force managers to earn their pay, and reduce the overall level of executive compensation. Section III.B uses evidence from the sample to test the hypotheses developed in Part II. In general, I begin with the high-level portrait painted by the larger sample, test for obvious confounding explanations of the findings using regression analysis, and then look closely at the case study sample to reveal a more detailed picture.

1. Assessing the Effect of the Reform: Evidence of Higher Costs and Regulatory Evasion.

Hypothesis one predicts that the reform will increase the costs associated with bankruptcy bonus plans and lead to regulatory evasion. I begin by assessing the impact of the reform on bankruptcy costs before moving on to the observed frequency of bonus plans and evidence that points to rampant regulatory evasion.

a. The Effect of the Reform on Bankruptcy Costs

As a threshold matter, by requiring the debtor's counsel to do extra work to approve a bonus plan, the 2005 reform and *Dana Corp.* may have increased the costs of bankruptcy.⁷⁴ To estimate the size of the increase, I

72. 11 U.S.C. § 327 (2018).

73. See First Verified Monthly Application of Alston & Bird LLP as Counsel for the Debtors and Debtors-in-Possession for Allowance of Compensation and Reimbursement of Expenses Incurred for the Interim Period June 22, 2009 through July 31, 2009 at 2, *In re Sea Launch Company*, No. 09-12153 (Bankr. D. Del. Aug. 25, 2009); see also FED. R. BANKR. P. 2016(a) (providing for the compensation of services provided to the debtor by professionals).

74. Others have speculated that the new, post-reform statutory regime requires more attorney time and expense. See Jonathan C. Lipson, *Where's the Beef? A Few Words About Paying for Performance in Bankruptcy*, 156 U. PA. L. REV. 64, 68 (2007).

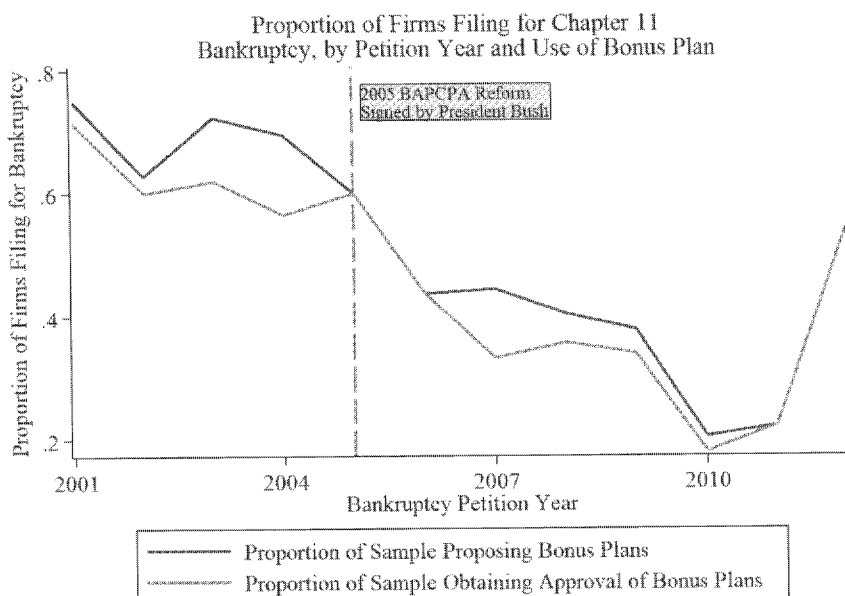
reviewed all of the debtor's counsel's bills and identified the time entries corresponding to work on a bankruptcy bonus plan. Pre-reform, the median debtor's counsel billed \$30,484 (mean of \$65,198) for work on a bankruptcy bonus plan in constant 2010 U.S. dollars.⁷⁵ Post-reform, the median debtor's counsel billed \$86,411 (mean of \$140,218) for their work on their debtor's bonus plans, an increase of 64%. For comparison's sake, the debtor's counsel's bill for the entire bankruptcy case was \$5,191,576 in the post-reform sample, as compared to \$3,449,969 pre-reform—an increase of 33%. The costs associated with a bankruptcy bonus plan grew twice as fast as the debtor's counsel's fees as a whole, suggesting that the new standard significantly increased the amount of legal work the debtor's attorneys needed to do to comply.⁷⁶

75. All of the nominal dollar amounts in the bills were adjusted to 2010 dollars using the Consumer Price Index.

76. In Appendix Table 1, I use regression analysis to try to verify that the observed fee increase is not due to a difference in observable firm characteristics between the population of pre-reform Chapter 11 debtors and post-reform Chapter 11 debtors. The results suggest that, controlling for firm financial characteristics and industry, the 2005 bankruptcy reform is associated with a 118% increase in the debtor's fees for time spent on bonus plans, a 102% increase in attorney's hours devoted to the bonus plan, and a 110% increase in the percentage of the total bill for the case devoted to matters related to the bankruptcy bonus plan.

b. The Effect of the Reform on Bonus Plan Utilization

FIGURE 1. Proportion of Firms Filing for Chapter 11 Bankruptcy, by Petition Year and Use of Bonus Plan



Notes: Figure 1 summarizes the proportion of firms filing for bankruptcy in each year of the large sample that either sought or obtained the approval of a bankruptcy bonus plan. For example, the data show that nearly 80% of 2001 bankruptcy filers sought and obtained approval of a bankruptcy bonus plan during their bankruptcy period. Bankruptcy bonus plans are typically proposed shortly after filing for bankruptcy, but in some cases the bonus plan may have been approved later.

The observed increase in costs associated with bonus plans is likely to deter other Chapter 11 debtors from implementing them. Sure enough, as Figure 1 shows, relying on the larger sample of the population of Chapter 11 debtors between 2001 and 2012, the percentage of firms filing for bankruptcy that seek a bonus plan falls precipitously after the 2005 reform, going from nearly 60% in 2004 to less than 40% in 2007.

It is difficult to conclude too much by examining the raw proportion of Chapter 11 firms with bonus plans, as the observed change could be a composition effect. For example, 2004 may have featured more firms in industries where bonuses are a larger part of executive compensation than

did 2007.⁷⁷ I cannot eliminate the possibility that a composition effect drives the shift observed in Figure 1, although it seems unlikely that this would be the whole explanation. I can, however, control for some observable firm characteristics in a regression analysis to test the robustness of the observed post-reform decline in the utilization of bankruptcy bonus plans, specifically by controlling for firm size, industry, and the debtor's law firm.

77. Some firms may be more likely to enact bonus plans if, for example, a large part of their pre-bankruptcy compensation was in the form of stock that is unlikely to be worth anything after bankruptcy. Thus, it is possible that a composition effect drives the effect in Figure 1, if the cohort of Chapter 11 debtors pre-reform were firms that used more stock compensation than the cohort that came afterwards. I addressed the question of pre-bankruptcy compensation practices further in *supra* Part I.

TABLE 1. Bonus Plan Proposal and Approval After the 2005 Reform

	(1) <i>Bonus Plan Proposed</i>	(2) <i>Bonus Plan Proposed</i>	(3) <i>Bonus Plan Approved</i>	(4) <i>Bonus Plan Approved</i>	(5) <i>Bonus Plan Proposed</i>	(6) <i>Bonus Plan Approved</i>
Post-BAPCPA Filing	-1.372*** (0.224)	-1.968*** (0.287)	-1.243*** (0.219)	-1.684*** (0.278)	-0.234*** (0.054)	-0.309*** (0.054)
N	409	388	409	408	445	408
Psuedo-R2	0.07	0.27	0.06	0.24	0.24	0.24
Firm Financial Controls	No	Yes	No	Yes	No	No
Industry FE	No	Yes	No	Yes	No	No
Law Firm FE	No	Yes	No	Yes	No	No
Propensity Score Matching	No	No	Yes	No	Yes	Yes

Notes: Table 1 displays logistic regression coefficients with robust standard errors in parenthesis. Firm financial controls include firm size. Industry fixed effects are Fama-French 12. Law firm fixed effects are indicator variables for the type of law firm advising the debtor on its reorganization: (1) national law firms with elite national bankruptcy practices, as ranked by Chambers and Partners (where “Band 1” firms in 2014 are considered elite practices); (2) full-service large New York based law firms listed in the American Lawyer list of the 250 largest law firms in 2014 that do not have “Band 1” bankruptcy practices; (3) full-service large law firms based anywhere but New York, listed on the American Lawyer list of the top 250 law firms in 2014; and (4) firms not listed in the American Lawyer list of 250 largest law firms. The propensity score models are estimated using nearest neighbor matching on firm size, law firm, and industry and are included as a robustness check of the main result.

Table 1 displays those regression results. In Models 1, 2, and 3, I regress a dummy variable for post-2005 reform filing on the likelihood of a bonus plan being proposed, with the second Model adding control variables. In Models 4, 5, and 6, I instead study the likelihood that a bonus plan is approved. In the cases of both proposal and approval, the results are the same: controlling for firm characteristics, firms become less likely to implement bankruptcy bonus plans after the 2005 reform.

c. The Effect of the Reform on the Overall Level of Executive Compensation

Given that proportionately fewer firms used court-approved bonus plans, it is possible that the overall level of executive compensation was reduced by the reform. To the extent the pre-reform equilibrium was characterized by managerial rent extraction, the reform might have eliminated some opportunistic retention bonus plans that effectively overcompensated managers.

While I am not able to measure overcompensation, I can look for evidence of a change in the level of compensation that managers receive before and after the 2005 reform. I take two approaches to doing so. First, for a subset of the large sample with available data, I calculate the percentage change in CEO compensation in the year prior to bankruptcy and the year the firm filed for bankruptcy.⁷⁸ This facilitates comparison of bankruptcy-period compensation to pre-bankruptcy-period compensation, controlling for the firm's historic level of compensation.

Second, to make sure that industry changes do not bias the analysis, I adjust each firm's observed CEO compensation to control for the firm's industry. For each firm in the sample, I identify the firm's industry using its three digit SIC code. I then use the ExecuComp dataset to identify S&P 1,500 firms in the same industry as each sample firm to understand how the sample firm's compensation compared to its industry peers. I then calculated a percentile ranking that reflects how the Chapter 11 debtor compared to its peers in each observed calendar year. So, for example, a firm in the 90th percentile in terms of compensation is a firm that paid their CEO more than 90% of all other firms in the same industry.

78. For example, if a firm's CEO was paid \$100 in the year before bankruptcy and \$120 in the year the firm filed for bankruptcy, the test statistic is $(\$120 - \$100) / \$100$, or 12%.

TABLE 2. Industry-Adjusted Bankruptcy Compensation, Before and After the 2005 Reform

	(1) <i>Percentage Change in Bankruptcy Compensation Compared to Pre- Bankruptcy Compensation</i>	(2) <i>Percentage Change in Bankruptcy Compensation Compared to Pre- Bankruptcy Compensation</i>	(3) <i>Percentage Change in Bankruptcy Compensation Compared to Pre- Bankruptcy Compensation</i>	(4) <i>Change in Industry Compensation Percentile, Pre- Bankruptcy vs. Bankruptcy</i>	(5) <i>Change in Industry Compensation Percentile, Pre- Bankruptcy vs. Bankruptcy</i>
Post-2005 Reform Filing	-1.296 (0.782)	-0.536 (0.448)	-0.326 (0.523)	-4.285 (6.174)	-0.365 (6.741)
Log Funded Debt	...	-0.664 (0.583)	-0.812 (0.664)	...	-2.663 (2.455)
Log Pre- Bankruptcy Compensation to Revenue Ratio	...	-0.713 (0.560)	-0.870 (0.623)	...	-2.758 (1.904)
R ²	0.03	0.11	0.21	0.00	0.02
N	110	99	99	110	99
Industry Fixed Effects	No	No	Yes	No	No

* $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$.

Notes: This table displays ordinary least squares regression with robust standard errors in parenthesis. For Models 1–3, the dependent variable is the percentage change in CEO compensation, pre-bankruptcy versus the first year of bankruptcy. For Models 4–5, the dependent variable is the difference in intra-industry compensation percentile, pre-bankruptcy versus the first year of bankruptcy. The intra-industry compensation percentile is the percentile ranking of how a firm's overall level of compensation compares to its industry peers (as identified by the firm's three digit SIC code) on the S&P 1500. By way of illustration, if an automaker's CEO compensation puts it at the 60th percentile in terms of automakers, it implies that the automaker pays better than 60% of automakers but less money than 40%, or slightly above average compensation. "Log Pre-Bankruptcy CEO Compensation to Revenue Ratio" is the ratio of the firm's CEO compensation over the firm's pre-bankruptcy revenue, a control for the amount of the firm's resources it dedicates to the CEO's compensation package. Industry fixed effects for Model 3 are Fama-French 12.

As Table 2 shows, I fail to find any statistically significant effect suggesting that the overall level of executive compensation in bankruptcy was altered by the reform. To be sure, my failure to find this relationship

does not mean there is not one. This analysis is conducted on a subset of the sample firms highly constrained by data availability, and it is possible that if the analysis included the missing firms the result would be different.⁷⁹ There may also be an omitted variable that would uncover an otherwise hidden relationship. However, at the very least, the results suggest that the lower rate of bonus plans might not have changed the overall level of compensation of Chapter 11 executives, relative to pre-bankruptcy compensation and industry trends.

d. Anecdotal Evidence of Regulatory Evasion

A potential explanation for this result is that firms may simply sidestep court-approved bonus plans to engage in regulatory evasion. I cannot offer comprehensive statistics on how frequently Chapter 11 debtors utilize these strategies, as firms do not necessarily go out of their way to disclose these strategies and are not necessarily required to do so. I also cannot rule out the possibility that the observed change in bonus plan utilization reflects improved governance of executive compensation. However, I find extensive anecdotal evidence suggesting that many firms are simply paying managers in ways that evade the judicial scrutiny demanded by the reform. There are three main strategies to get around the 2005 reform: (1) adjusting compensation pre-bankruptcy; (2) paying bonuses as part of other bankruptcy court orders that the 2005 reform does not regulate; and (3) waiting until after the firm emerges from bankruptcy to pay bankruptcy related-bonuses. I explain each strategy in turn.

First, the reform does not affect compensation adjustments that firms made before filing for Chapter 11 bankruptcy, and some firms appear to have taken advantage of this.⁸⁰ A Chapter 11 debtor cannot simply pay management a large bonus on the eve of bankruptcy, as doing so might create an avoidable transfer that creditors could recover.⁸¹ However, at

79. The firms in Table 2 all had historic and bankruptcy-year compensation data publicly available, either in securities filings or in the bankruptcy court documents that I reviewed to assemble the sample. It is possible that the missing firms are non-randomly selected, so the results in this Section should be interpreted cautiously. In general, firms tend to avoid disclosing executive compensation numbers if they can, viewing it as a trade secret, so the firms in Table 2 tend to skew towards the largest firms.

80. From the large sample, both OTC Holdings and Regent Communications engaged in this type of planning. I studied both cases closely for my article, *Do Activist Investors Constrain Managerial Moral Hazard In Chapter 11?: Evidence from Junior Activist Investing*, *supra* note 35. Stumbling upon them—and their thoughtful and successful attempts to use bankruptcy planning to evade court review—inspired this project.

81. One law firm that represents many large debtors in bankruptcy expressly warned its clients against this strategy, saying that it risked upsetting negotiations with creditors and created fraudulent conveyance risk. Sprayregen et al., *supra* note 21. Anecdotal evidence suggests that this practice is both

least some firms implemented bankruptcy-related bonus plans prior to filing for Chapter 11 that were overt and open attempts to evade the 2005 reform. For example, OTC Holdings, a manufacturer of party supplies and children's toys, set up a Key Employee Performance Incentive Plan ("KEPIP") to "align the interests of OTC's key employees with the interests of OTC and its creditors" prior to the firm's bankruptcy petition.⁸² This plan was designed to pay bonuses only after the firm emerged from bankruptcy, which, the firm argued, meant that the Bankruptcy Code's restrictions on executive bonuses would not apply to the incentive plan.⁸³ Similarly, the board of directors of Regent Communications implemented a "Special Bonus Plan . . . [which] was triggered upon commencement of the Chapter 11 Cases," suggesting that OTC is, at the very least, not the only firm that engaged in this sort of bankruptcy planning.⁸⁴

Second, some firms simply "bundled" bankruptcy bonus plans with other, more important motions to evade close court monitoring of bankruptcy-related compensation.⁸⁵ When large firms file for bankruptcy, they usually also file a variety of intermediate motions while they try to reorganize their business—a motion for a bonus plan is an example of such an intermediate motion—before filing a proposed plan of reorganization for the approval of the bankruptcy judge. The plan of reorganization is a lengthy document that contains hundreds of provisions that describe how the firm will leave bankruptcy, how it will pay its creditors, and what the post-bankruptcy life of the company will be. Bankruptcy law instructs the judge to evaluate this document under section 1129 of the Bankruptcy Code.⁸⁶ The approval of this document will normally end the bankruptcy

common and continuing to this day. See Andrew Scurria, *Takata Insiders Took in Millions Before Bankruptcy*, WALL ST. J. PRO: BANKR. (Aug. 10, 2017), <https://www.wsj.com/articles/takata-insiders-took-in-millions-before-bankruptcy-1502405497>.

82. Disclosure Statement Under 11 U.S.C. § 1125 in Support of the Debtors' Third Amended Joint Plan of Reorganization at 26–27, *In re OTC Holdings Corp.*, No. 10-12636 (Bankr. D. Del. Nov. 2, 2010), ECF No. 263.

83. See *id.*

84. First Amended Disclosure Statement for the First Amended Joint Plan of Reorganization for Regent Commc'ns Corp., et al. at 24, *In re Regent Commc'ns, Inc.*, No. 10-10632 (Bankr. D. Del. Mar. 22, 2010), ECF No. 128. A third non-case study sample, the 2009–2010 Chapter 11 of CCS Medical, involved similar bankruptcy planning and similarly allowed management to be paid bankruptcy-related bonuses without a judge finding that the plan satisfied the revised statute. See Transcript of Hearing re Debtors' Motion for Order (a) Approving Bidding Procedures in Connection with Mktg. and Proposed Sale of Substantially All of the Debtors' Assets, and (b) Granting Related Relief at 37–38, *In re CCS Medical, Inc.*, No. 09-12390 (Bankr. D. Del. Nov. 23, 2009), ECF No. 673.

85. Importantly, I only count bankruptcy bonuses that are bundled with the plan of reorganization and pay cash consideration as part of the analysis in this paragraph.

86. See 11 U.S.C. § 1129 (2018).

case and allow the firm to emerge as a restructured company. Adding a retroactive bankruptcy bonus plan into this document is as simple as adding a single line of text.

By “bundling” the executive bonus plan with the larger plan of reorganization, a Chapter 11 debtor can evade the scrutiny that comes when the bonus plan is squarely before the court. This strategy also puts the judge in a difficult position, as it creates a choice between approving the plan of reorganization (with the bundled executive bonus plan) or rejecting the plan, when rejecting the plan might mean forcing the company to remain in bankruptcy with unknown costs for the business and its employees.

As such, it should not be surprising that “bundling” was the most commonly observed regulatory evasion strategy. For example, in the bankruptcy of Journal Register, management abandoned an attempt to obtain judicial approval of a bankruptcy bonus plan after the pension fund objected. But management did not abandon the goal of paying itself for bankruptcy-related performance. Instead, the company bundled a “bankruptcy emergence bonus” into the plan of reorganization, which, it reasoned, was governed by a different part of the Bankruptcy Code than section 503(c).⁸⁷ In evaluating this attempt at bundling, the court first noted that the debtors “filed a motion during the cases for approval of the Incentive Plan, but thereafter withdrew that motion and incorporated the Incentive Plan in the Reorganization Plan.”⁸⁸ However, the court also pointed out that the plan process involved creditor voting and the creditors—whose money was going to the executives—supported the plan.⁸⁹ Accordingly, the judge approved the payment of the bonuses.⁹⁰

87. See *In re Journal Register Co.*, 407 B.R. 520, 527, 537 (Bankr. S.D.N.Y. 2009) (noting the court agreed that the confirmation of a plan is governed by section 1129, not section 503(c), of the Bankruptcy Code).

88. *Id.* at 535.

89. *Id.* at 528, 537.

90. *Id.* at 538. In collecting data for Ellias, *supra* note 35, I observed other firms engage in similar behavior without first seeking court approval of a bonus plan. For example, Carastar Industries paid management 50% of its 2009 incentive compensation on the effective date of the plan of reorganization. See Disclosure Statement for Debtors' Joint Plan of Reorganization at 40, *In re Carastar Indus., Inc.*, No. 09-73830 (Bankr. N.D. Ga. May 31, 2009), ECF No. 21. Orleans Homebuilders paid \$2.3 million in bonuses to forty senior managers as part of its plan of reorganization. See Debtor's Second Amended Joint Plan of Reorganization at 44, *In re Orleans Homebuilders, Inc.*, 561 B.R. 46 (Bankr. D. Del. 2010) (No. 10-10684). Other firms paying large bonuses as part of the plan—presumably for performance during the bankruptcy case—that filed for bankruptcy in 2009 and 2010 include: Lyondell Chemical Company (\$27.75 million); Reader's Digest Association (\$12.9 million); Visteon Corporation (\$8.1 million for twelve managers); Mesa Air Group, Inc. (\$5.5 million); Six Flags, Inc. (\$5.025 million for seven managers); Innkeepers USA Trust (\$4.5

Finally, a third strategy to evade court monitoring of bankruptcy-related executive compensation is deferring bonuses for bankruptcy-related conduct for the post-bankruptcy board of directors.⁹¹ Once a firm leaves bankruptcy, it is no longer under judicial supervision and can pay its employees however much it wants. As such, boards of directors can sidestep the 2005 reform by promising management a bonus that is never formally contracted for or paid until the firm emerges from bankruptcy.

While post-bankruptcy executive compensation is, by definition, hard to survey in detail, I did observe strange behavior in the bankruptcy of Citadel Broadcastings, a radio station conglomerate that filed for bankruptcy in late 2009.⁹² Citadel proposed a plan of reorganization that, like most cases in the sample, included setting aside a percentage of the firm's post-reorganization equity for managers.⁹³ This plan of

million); Almatix B.V. (\$4.3 million); Tronox Incorporated (\$3 million for four managers); Cooper-Standard Holdings, Inc. (\$2.49 million for thirteen managers); Orleans Homebuilders, Inc. (\$2.38 million for forty managers); NTK Holdings, Inc. (Nortek, Inc.) (\$2 million); FairPoint Communications, Inc. (\$1.8 million); Journal Register Company (\$1.7 million); Affiliated Media, Inc. (\$1.6 million for fifty employees); Centaur, L.L.C. (\$1.5 million for three managers); Great Atlantic & Pacific Tea Company, Inc. (\$1.48 million for 146 managers); Panolam Industries International, Inc. (\$1 million); EnviroSolutions Holdings, Inc. (\$1 million); Pliant Corporation (\$0.87 million for one manager); International Aluminum Corporation (\$0.65 million); Newark Group, Inc. (\$0.5 million); Oriental Trading Company, Inc. (\$0.45 million for fourteen managers); Neff Corp. (\$0.35 million for two managers); and Regent Communications, Inc. (\$0.31 million).

91. Congress has long recognized the need for public disclosure of post-bankruptcy compensation and retention of bankruptcy insiders. *See, e.g.*, 11 U.S.C. § 1129(a)(5)(B) (2018) (requiring disclosure of the identity of insiders who will be employed or retained by the debtor as well as their compensation).

92. *See* Voluntary Petition (Chapter 11), *In re Citadel Broadcasting Corp.*, No. 09-17442 (Bankr. S.D.N.Y. Dec. 20, 2009).

93. Objection of Virtus Capital LLC and Kenneth S. Grossman Pension Plan to the Disclosure Statement for the Joint Plan of Reorganization of Citadel Broadcasting Corp. and Its Debtor Affiliates Pursuant to Chapter 11 of the Bankr. Code at 4–5, *In re Citadel Broadcasting Corp.*, No. 09-17442 (Bankr. S.D.N.Y. Mar. 5, 2010), ECF No. 172. Post-bankruptcy equity incentive plans are largely outside the scope of this study because of data constraints. While I often observe firms setting aside post-reorganization equity for a management incentive plan as part of the plan of reorganization, I do not systematically observe the post-bankruptcy payouts. Citadel is an outlier case because it involved management misrepresenting the post-bankruptcy incentive plan to the court, with creditors learning about it and seeking some sort of remedy. The vast majority of Chapter 11 debtors do not become publicly traded immediately after bankruptcy; accordingly, there is little disclosure of post-bankruptcy equity compensation. The value of post-bankruptcy equity compensation is substantial and dwarfs all observed bankruptcy bonus plans (for the 2009 and 2010 sample, the aggregate amount of value in all of the bonus plans in the case study sample is \$70 million; those same firms set aside approximately \$387 million in aggregate management post-bankruptcy equity incentive plans). However, without information on post-bankruptcy distributions and understanding how equity was allocated across the employee base, it is impossible to determine how much of this equity actually flowed to management and how much may have flowed to management as a form of compensation for performance while the firm was in Chapter 11.

reorganization was hotly contested by hedge fund creditors, who charged that management was undervaluing the firm and going to profit in the form of underpriced post-bankruptcy stock grants.⁹⁴ In response to the criticism, the CEO testified in court, “I have tried to get stock and each time I was told I am getting options at market value . . . [that] will vest one-third each year on the anniversary from the time I got those options. So they will be actually vest[ed] three years from now.”⁹⁵

The company thus dealt with the charge of self-dealing in an elegant way. Instead of an outright stock grant, management received out-of-the-money or market value stock options, which meant that management could not use those stock grants to extract value that should have gone to creditors. After hearing this testimony, the judge confirmed the plan of reorganization.⁹⁶

This testimony appears to have been forgotten shortly after the firm exited bankruptcy. Less than a month after leaving Chapter 11, reorganized Citadel distributed the stock in the form of restricted stock grants that vested on a two-year schedule.⁹⁷ The CEO alone received \$55 million, making him the highest paid manager in the history of the radio industry.⁹⁸ These stock grants were only publicly disclosed due to Citadel’s obligations as an issuer of public debt. The disclosures caught the ire of the activist investors who had lost in court at the confirmation hearing.⁹⁹ They filed a motion seeking to “prevent one of the most egregious frauds by a company emerging from bankruptcy under Chapter 11.”¹⁰⁰ They noted that this conduct was “fraudulent because Citadel representatives, including [the CEO] himself, repeatedly told this Court, under oath, that they were not getting under the Plan the very securities that they gave themselves only weeks later immediately upon emergence [from bankruptcy].”¹⁰¹

The *Citadel Broadcasting Corp.* case is an outlier, however. I have not come across any other cases with similar facts. However, the 408 firms in

94. *See id.*

95. Reply of R² Investments, LDC in Support of Motion Pursuant to 11 U.S.C. §§ 1142 and 105(a) to Direct Reorganized Debtors to Comply with Plan ¶ 5, *In re Citadel Broadcasting Corp.*, No. 09-17442 (Bankr. S.D.N.Y. Oct. 29, 2010), ECF No. 507.

96. Motion Pursuant to 11 USC §§ 1142 and 105(a) to Direct Reorganized Debtors to Comply with Plan at 2, *In re Citadel Broadcasting Corp.*, No. 09-17442 (Bankr. S.D.N.Y. Oct. 6, 2010), ECF No. 498.

97. *Id.* at 3.

98. *Id.* at 2.

99. *See id.* 1–5.

100. *Id.* at 1.

101. *Id.* at 2.

the large sample set aside more than \$400 million in post-bankruptcy equity for post-bankruptcy management incentive plans. To be sure, most large companies have some sort of equity incentive plan, and it is entirely in the ordinary course for companies to compensate managers with stock. But other research has noted that creditors sometimes persuade managers to support their incentive plan with lucrative post-bankruptcy employment contracts.¹⁰² Thus, it remains an open question how often managers are rewarded after the firm emerges from bankruptcy for conduct that took place during bankruptcy.

2. Assessing the Limitations of the Bankruptcy Judge

As hypothesis two discussed above,¹⁰³ bankruptcy judges suffer from an informational asymmetry and lack of expertise that make it difficult for them to make the determination that the 2005 reform wants them to—that a bonus plan is an “incentive plan” with challenging goals and not a “disguised retention plan.” To assess this hypothesis, I first examine how the structure of bonus plans changed after the reform and then determine whether the post-2005 bonus plans are substantively different than the retention plans that Congress banned.

102. Goldschmid, *supra* note 28, at 266–67.

103. *See supra* Part II.

a. Changes in Bonus Plan Structure

TABLE 3. Bonus Plan Structure, Before and After the 2005 Reform

	Post-2005 Sample (n=57)			Pre-2005 Sample (n=43)		
	N	Mean	Median	N	Mean	Median
Panel A. Plan Summary Statistics						
Number of Days Before Proposal of Plan	57	78.00	54.00	43	120.77	0.00
Maximum Employees Participating	47	202.79	25.00	42	67.52	34.50
Percentage of Total Employees Participating	31	22.69%	1.11%	16	13.59%	2.89%
Senior Managers Participating	42	21.29	7.00	32	10.06	7.00
Percentage of Participants Senior Managers	39	55.57%	43.18%	31	38.55%	23.81%
CEO Included (1/0)?	42	0.60	1	28	0.54	1
Maximum Bonus Pool Size (\$)?	50	6,815,421	2,035,000	39	3,353,348	2,000,000
Pool Size as a % of debt	38	0.78%	0.58%	14	1.05%	0.96%
Pool Size as a % of assets	43	3.67%	0.53%	37	24.96%	1.30%
Panel B. Bonus Plan Pay-Out Events						
EBITDA Target (0/1)	53	0.30	0	43	0.21	0
Revenue Target (0/1)	55	0.07	0	43	0.07	0
Cost Reduction Target (0/1)	55	0.11	0	43	0.00	0
Cash Target (0/1)	54	0.09	0	43	0.00	0
Production Target (0/1)	55	0.09	0	43	0.02	0
Creditor Recovery Target (0/1)	55	0.05	0	43	0.00	0
Any Operational Target (0/1)	57	0.46	0	43	0.23	0
Asset Sale Date Target (0/1)	55	0.24	0	43	0.14	0
Whole Firm Sale Date Target (0/1)	54	0.31	0	43	0.38	0
Plan Confirmation Date Target (0/1)	55	0.51	1	43	0.51	1
Emergence Date Target (0/1)	54	0.30	0	43	0.21	0
Bankruptcy Related Targets (0/1)	57	0.86	1	43	0.86	1
Termination or Retention Pay-out (0/1)	57	0.18	0	43	0.95	1

Table 3 summarizes differences in the structure of bonus plans from the case study sample before and after the reform. As Table 3 shows, the reform clearly changed the structure of bankruptcy bonus plans.¹⁰⁴ While bonus plans did not appear to change much in terms of the amount of money set aside for bonuses, the bonus plans after the reform are much more likely to include some sort of operational or financial target that rewards management for meeting specific performance objectives.¹⁰⁵ Bankruptcy-related objectives remain very popular, such as paying management a bonus when the court confirms a plan of reorganization. But in the post-reform era, approximately 20% of the plans with bankruptcy "milestone" bonuses were tied to the specific milestone occurring by a specific date, which makes them more challenging to accomplish.

b. Do the Post-Reform Bonus Plans Appear to Be Challenging Incentive Plans?

Of course, these changes could very well be superficial. Unfortunately, much like a bankruptcy judge, I cannot directly measure the extent to which these plans created "truly incentivizing goals," because that would require perfect knowledge of the facts and circumstances at the time the bonus plan was adopted. Whether a revenue goal is challenging, for example, would depend on observing the probability distribution of hitting the revenue goal, which I obviously cannot do.

I can, however, examine theoretical predictions that indirectly capture an aspect of how challenging the bonus plans would have been considered. First, we would expect the post-reform plans to pay managers at a lower rate than the pre-bankruptcy bonus plans, because challenging performance goals are likely to be missed more often than the pre-bankruptcy retention plans that rewarded managers for staying at their desks. Second, theory would predict that, as the risk associated with a bonus increases, so too should the size of the bonus, to compensate management for the increased risk of not hitting the challenging goal. For example, a \$100 bonus might be an effective motivating tool if management knows there is a 100% chance of receiving the payment. But if there is only a 10% chance of

104. An important limitation of the data is that in many cases, bonus plans were either incomplete when filed with the court or filed under seal. Accordingly, Table 3 reports the information that was publicly available both from bankruptcy court filings and from contemporaneous or post-bankruptcy SEC filings that filled in gaps from the court filings.

105. This is consistent with anecdotal reports of practitioners. For example, a prominent creditor's attorney told Bloomberg that "the amendment to the code changed the means, but not the value of these plans . . . [i]t's just changed the way you get there, not necessarily how much management gets at the end." Church, *supra* note 7.

receiving the payment, management would need a much larger bonus to provide the same motivation to perform.¹⁰⁶ I assess each of these predictions in turn.

TABLE 4. Incentive Plan Target Achievement Rate, Before and After the 2005 Reform

	Post-2005 Reform Bonus Plan Targets Achieved?			Pre-2005 Reform Bonus Plan Targets Achieved?		
	Yes	No	Unknown	Yes	No	Unknown
EBITDA						
Targets?	18.75%	18.75%	62.5%	11.11%	33.33%	55.56%
Asset Sales						
Targets?	69.23%	23.08%	7.69%	66.67%	33.33%	N/A
Whole Firm						
Sale Targets?	82.35%	11.76%	5.88%	37.5%	62.5%	N/A
Plan						
Confirmation						
Targets?	60.71%	32.14%	7.14%	72.73%	27.27%	N/A
Emergence?	81.25%	12.5%	6.25%	66.67%	22.22%	11.11%
Any Target						
Hit?						
(including						
retention in						
pre-2005 era)	93.75%	6.25%	N/A	88.89%	11.11%	N/A

First, I analyzed every stated goal from every court-approved bankruptcy bonus plan in the case study sample. I then used information from the court docket and subsequent public information (such as securities filings) to determine whether the bonus plan paid out.¹⁰⁷ As Table 4 shows,

106. In expectation, the expected value of \$100 in the future that will be received with 100% certainty is \$100 ($\$100 \times 100\%$). If management only has a 10% chance of receiving the bonus, in expectation that bonus is worth \$10 ($\$100 \times 10\%$). Thus, the board would need to propose a bonus plan that paid \$1000 as part of a challenging incentive plan with a 10% ex ante probability of payout (because $\$1000 \times 10\% = \100) to provide the same level of motivation as a guaranteed retention bonus of \$100.

107. For example, if a bonus plan was tied to confirming a plan of reorganization by a certain date, we examined whether the bonus plan was approved by that date or if there was a subsequent extension.

the rate of payout appears to be similar across both time periods.¹⁰⁸ This finding at least casts doubt on the view that the post-reform bonus plans are different as a matter of substance, in addition to being procedurally different from the pre-reform plans.¹⁰⁹

Second, I examine the schedule of payments under the bonus plan to look for evidence that the payouts were increased to compensate management for the increased risk of an incentive plan. After adjusting the proposed maximum payouts for inflation, I find that CEOs received nearly identical bonuses after the reform as they did under the pre-bankruptcy retention bonus plans. Post-2005, firms implementing court-approved bonus plans planned to pay a 30% year-over-year increase in CEO compensation for the first year of bankruptcy, as compared to 29.3% for the firms implementing bonus plans in the sample years before the reform. A caveat to this analysis is that firms may have wanted to implement bonus plans but felt restricted by the bankruptcy judge, so the observed maximum bonus plans might be censored. However, this finding casts doubt on the argument that these “incentive” bonuses are much riskier than the pre-bankruptcy retention plans.

3. Assessing the Role of Creditors and the U.S. Trustee

Bankruptcy law, of course, understands that the bankruptcy judge cannot ever know as much about a debtor as its management team and relies on creditors and the Department of Justice’s U.S. Trustee Program to police abuses. As hypothesis three predicts, there are two theoretical problems that might constrain the willingness and ability of the creditors and U.S. Trustee to monitor executive compensation. The first is that the creditors lack strong incentives to invest time and money into monitoring relatively small bonus plans, as bonus plans represent only a small percentage of the overall value on the table in a bankruptcy plan. The second is that the U.S. Trustee suffers from a similar expertise deficit as the judge, making it just as hard for the U.S. Trustee to distinguish challenging

108. The exception is a higher observed rate of payout for firms with whole firm sale targets and payouts for emerging from bankruptcy. This likely reflects changes in bankruptcy practice, as it became more common for firms to go into Chapter 11 and conduct going-concern sales. *See, e.g.,* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 751, 786–88 (2002) (discussing the rise in the use of Chapter 11 as a platform for the sale of a firm’s assets, often as a whole firm going-concern sale).

109. This finding deserves two qualifications. As Table 4 shows, there is enough missing data to potentially bias the result. Additionally, bonus plans often have “tiers” of goals (as where, for example, a 10% revenue increase might yield \$100 and a 15% revenue increase might yield \$200), and I do not systematically examine enough information to determine which payout tier was reached in enough cases to report results.

incentive plans from disguised retention plans. I analyze evidence of the role played by creditors and the U.S. Trustee Program in turn.

a. The Observed Role of Creditors

In theory, creditors have limited incentives to police executive compensation. While it is true that creditors are generally the residual claimants of the firm, and thus the party that loses if management extracts unearned compensation,¹¹⁰ their economic incentives are to focus more on the hundreds of millions or billions of dollars that are at stake in large bankruptcy cases, not the relatively small amount of money involved in bonus plans.

110. For example, if management would have worked for \$100, but extracts extra rents of \$50 for total compensation of \$150, the extra \$50 is money that could have otherwise been paid (in some form or another) to unsecured creditors in the event they are not being paid in full.

TABLE 5. Summary of Creditor and US Trustee Arguments Objecting to Proposed Bonus Plans

<i>Argument Made in Objection</i>	<i>Any Objector</i>	<i>Official Committee</i>	<i>Secured Creditor</i>	<i>Unsecured Creditor</i>	<i>U.S. Trustee</i>
Disguised Retention Plan	59.65%	33.33%	8.77%	3.51%	43.86%
Post-Reform Change	N/A	N/A	N/A	N/A	N/A
Incentives Not Clearly Defined?	47.37%	19.3%	8.77%	5.26%	36.84%
Post-Reform Change	69.74%	38.3%	277.19%	126.32%	692.11%
Incentives Not Hard Enough to Achieve?	42.11%	17.54%	5.26%	5.26%	26.32%
Post-Reform Change	126.32%	88.6%	N/A	126.32%	1031.58%
No Need for Bonuses in this Case	59.65%	26.32%	12.28%	5.26%	42.11%
Post-Reform Change	97.3%	61.65%	428.07%	126.32%	352.63%
Bonuses Are Too High (Generically)	40.35%	14.04%	10.53%	7.02%	19.3%
Post-Reform Change	33.47%	-13.78%	13.16%	201.75%	314.91%
Bonuses Are Too High (for Industry)	26.32%	8.77%	5.26%	1.75%	8.77%
Post-Reform Change	182.89%	25.73%	N/A	N/A	N/A
Bonuses Are Too High (Based on this Company's history)	19.3%	7.02%	1.75%	1.75%	8.77%
Post-Reform Change	-7.8%	-49.71%	-24.56%	N/A	277.19%
All Legal Arguments	66.67%	33.33%	12.28%	7.02%	47.37%
Post-Reform Change	68.63%	79.17%	32.02%	201.75%	307.37%

Note: This table summarizes observed arguments in written objections filed to proposed bonus plans in the post-2005 reform sample period (2009 and 2010) and shows how that litigation compares to the litigation observed for the pre-2005 sample. For example, post-reform, the official committee of unsecured creditors filed an objection arguing that the incentives were not hard enough to achieve in 17.54% of the cases in which a bankruptcy bonus plan was proposed by management, which is an 88.6% increase from the pre-reform baseline. Across the sample of cases, one of the parties in this table—either the official committee, a secured or unsecured creditor, or the U.S. Trustee—filed an objection making that argument in 42.11% of cases, an 126.32% increase from the pre-reform baseline.

To see how creditors actually used their bargaining power, I reviewed all of the objections the official committee of unsecured creditors filed in response to the firm's motion seeking bonus plan approval; those objections are summarized in Table 5.¹¹¹ There are limits to reviewing the objections of the official committee, as doing so does not reveal how creditors may have negotiated in the shadow of their right to object, nor does it capture how creditors might have influenced bonus plans before they were even proposed by the court. Accordingly, caution is needed in interpreting this Section, as it relies on an incomplete record of creditor influence on negotiations. In the Appendix, I present a summary Table, which shows how bonus plans changed between being proposed on the docket and being approved by the court. The Appendix Table suggests, at least on paper, that Chapter 11 debtors are forced to make performance goals more challenging in response to creditor demands.¹¹²

As Table 5 shows, official committees became much more litigious after the 2005 reform. They filed written objections to 33% of the proposed bonus plans, a 79% increase from the pre-reform sample. Categorizing the objections, the most common legal argument—expressed in every case in which the official committee objected—was that the bonus plan was a disguised retention plan, violating the 2005 reform. This observed litigation is obviously only a small part of their influence, as they almost certainly negotiated in the shadow of their right to object and may have influenced many bonus plans in unobserved ways.

However, creditor objections seldom presented particularized criticisms of the proposed bonus plan. Creditors did file objections to the proposed bonus plans alleging that the compensation level exceeded industry standards in 26% of cases (as compared to 9% before the reform), but that was only 40% of the cases for which an objection was filed. More importantly, creditors only offered evidence from an opposing expert in 8% of cases (as compared to 11% prior to the reform). For the five cases where the official committee complained about the bonus plan exceeding industry standards, one offered evidence from other Chapter 11 cases,¹¹³ one simply

111. In some cases, creditors file their own objections, either because they are secured creditors who are not represented by any official committee or because they want to act on their own, apart from the committee, for strategic reasons. I also summarize the litigation of these creditors as part of Table 4. The qualitative trends I discuss in this Section, while focusing on the official committee, are the same as the trends observed by unsecured creditors acting on their own.

112. It is difficult to evaluate this because managers may simply propose an unreasonable bonus plan before moving the plan to what they know creditors will accept after negotiations and litigation. It is hard to know if management actually "moved" or simply went to where they always planned to be.

113. Objection of the Official Comm. of Unsecured Creditors to the Motion of the Debtors and

pointed to the dire climate of the industry,¹¹⁴ two complained that the numbers were high without supporting evidence of “competitive compensation in the [company’s] industry,”¹¹⁵ and one asked for management to provide more information.¹¹⁶ In no objection in the case study sample was the judge provided with concrete numbers that could be used to compare the bonus plan to an industry standard.

The *Foamex Int’l, Inc.* bankruptcy litigation provides a representative example of a typical official committee objection to a proposed bonus plan. Foamex’s management originally sought approval of a bonus plan that would pay out in the event that the company successfully sold its assets.¹¹⁷ The committee first complained that the bonus plan motion was filed “within the first few weeks of the case” and while the debtors were attempting to sell the firm on a faster schedule than the committee wanted.¹¹⁸ The committee then complained that management was likely not only to get the bankruptcy bonuses but also “generous employment agreements” if the planned sale went through.¹¹⁹ The committee further deemed the bonus plan targets “effortless” and instead demanded that the company link incentive compensation to “the payment of a dividend to general unsecured creditors.”¹²⁰ Nowhere in the objection is there any analysis of the underlying compensation plan itself. There are only bald complaints about how the committee disagreed with the idea of rewarding management for a sale and preferred management receive a bonus in the

Debtors in Possession for Entry of an Order Approving a Key Employ. Incentive Plan at 8, *In re Midway Games, Inc.*, No. 09-10465 (Bankr. D. Del. Mar. 27, 2009), ECF No. 203.

114. Objection of the Official Comm. Of Unsecured Creditors to Debtor’s Motion for Order Approving the Implementation of Key Emp. Incentive Plan and Short Term Incentive Plan at 2, *In re Hayes Lemmerz Int’l, Inc.*, No. 09-11655 (Bankr. D. Del. Aug. 14, 2009), ECF No. 460 [hereinafter Hayes Lemmerz Objection].

115. Objection of the Official Comm. Of Unsecured Creditors to Debtor’s Motion for Order Authorizing Use of Cash Collateral for Payments Regarding HVM LLC Incentive Program at 28, *In re Extended Stay Inc.*, No. 09-13764 (Bankr. S.D.N.Y. Oct. 26, 2009), ECF No. 530; Objection of Official Comm. Of Unsecured Creditors to Motion of the Debtors for an Order Authorizing the Debtors to Continue Their Short-Term Incentive Plan at 12–13, *In re Merisant Worldwide, Inc.*, No. 09-10059 (Bankr. D. Del. Mar. 20, 2009), ECF No. 211.

116. Objection of the Official Comm. Of Unsecured Creditors to: (A) Debtors’ Motion for an Order Authorizing the Debtors to Implement Severance and Non-Insider Retention Programs; and (B) Debtors’ Motion for an Order Authorizing the Implementation of the Visteon Incentive Program at 8–10, *In re Visteon Corp.*, No. 09-11786 (Bankr. D. Del. Jul. 13, 2009), ECF No. 528.

117. Objection of the Official Comm. of Unsecured Creditors to Debtors’ Motion for Order Authorizing Debtors to Adopt and Implement an Incentive Plan for Certain Key Employ. Pursuant to Sections 363(b)(1), 503(c)(3), and 105(a) of the Bankr. Code at 13, *In re Foamex Int’l, Inc.*, 368 B.R. 383 (Bankr. D. Del. 2007) (No. 09-10560).

118. *Id.* at 1–2.

119. *Id.* at 2.

120. *Id.* at 2–4.

event a plan of reorganization was approved, preferably one paying unsecured creditors a significant recovery.¹²¹

Other official committee objections in the sample served as a similar opportunity for the official committee to negotiate the plan of reorganization through litigation. The lack of substance in some of these objections suggests that the objection itself is better understood as a chance to express a partisan view about how the Chapter 11 case should proceed. For example, in the bankruptcy case of *Trico Marine Servs., Inc.*, the official committee informed the court that it objected because the committee was at loggerheads with management over how the case would proceed.¹²² In the bankruptcy of NEFF Corp., the official committee complained that the Management Incentive Plan incentivized management to approve a plan favored by senior lenders and not “explore alternative plan strategies.”¹²³ Similarly, in the Hayes Lemmerz bankruptcy, the creditor’s committee complained that bonuses should not be paid “for merely confirming a plan quickly for the benefit of the Debtors’ secured lenders who . . . were involved in the design and approval of the [bonus plan.]”¹²⁴

b. The Observed Role of the Department of Justice’s U.S. Trustee Program

Unlike creditors, the Department of Justice’s U.S. Trustee Program only has incentives to enforce bankruptcy policy. The trouble with the U.S. Trustee’s frequent interventions, as described further below, is that the body largely lacks the expertise needed to effectively police executive compensation.

Sure enough, as Table 5 shows, the U.S. Trustee became far more litigious after the reform, objecting to almost half of filed bonus plans, a 300% increase from the pre-reform sample.¹²⁵ The U.S. Trustee objection

121. See *id.* at 2–5.

122. Official Comm. Of Unsecured Creditors’ Objection to Debtors’ Motions to Shorten Notice Relating to Their (I) Motion for Approval of Exec. Comp. and Emp. Incentive Plan for Non-Debtor OpCo Subsidiaries and (II) Motion to File Related Exhibits Under Seal at 2–3, *In re Trico Marine Servs., Inc.*, 450 B.R. 474 (Bankr. D. Del. 2011) (No. 10-12653).

123. Debtors’ Reply to the Objection of the Official Comm. of Unsecured Creditors to Motion of the Debtors for Entry of an Order Approving the Debtors’ Key Employee Incentive Plan at 2, *In re NEFF Co.*, No. 10-12610 (Bankr. S.D.N.Y. Jun. 28, 2010), ECF No. 199. In response, the debtors moved the “emergence incentive award” to the plan of reorganization. *Id.* at 3; see also *supra* note 90 and accompanying text.

124. Hayes Lemmerz Objection, *supra* note 114, at 3.

125. In one case, the Debtor complained that the U.S. Trustee’s objection “appears to be based on a form and ignores the evidence [the debtor] submitted.” Tronox’s Response to the Objection of the

in the Lear Corporation bankruptcy is fairly representative of U.S. Trustee objections in the sample.¹²⁶ The Trustee first asserted that the proposed incentive plan is actually a disguised retention plan on the grounds that the milestones are too easy to achieve.¹²⁷ To support this claim, the U.S. Trustee pointed out that the major bankruptcy-related milestones have to do with filing a plan of reorganization, which, the U.S. Trustee noted, has already been mostly negotiated by the time the firm filed for bankruptcy.¹²⁸ Accordingly, this is not the type of “challenging result” that “warrant[s] a bonus.”¹²⁹ The U.S. Trustee also noted that the responsibility of preparing a plan of reorganization mostly falls on the debtors’ lawyers—not the managers—meaning managers do not deserve a bonus for work done by their lawyers.¹³⁰ The Trustee then noted that the financial targets for part of the bonus payment were not disclosed, and therefore, may be too easy. Therefore, the Trustee demanded that management produce more evidence to satisfy its burden of proof.¹³¹

This sort of conclusory analysis characterizes many other U.S. Trustee objections in the sample. In one case, the U.S. Trustee condemned a bonus plan linked to asset sales by declaring that the plan simply “require[s] the employees to do their jobs” and was not “tied to any specified sales activity or task.”¹³² In another case, the U.S. Trustee objected that a bonus plan linked to an asset sale paid managers “based on the first dollar of proceeds” and was thus insufficiently incentivizing.¹³³ In another example, the U.S. Trustee pointed out that a different sale incentive plan would create rewards “determined in large part by complicated macroeconomic, market and industry-specific forces” and that management’s contribution to the effort would be minimal, calling the incentivizing nature of the plan into

U.S. Tr. to Tronox’s Motion for Entry of an Order Approving Tronox’s Key Emp. Incentive Plan at 2, *In re Tronox, Inc.*, 503 B.R. 239 (Bankr. S.D.N.Y. 2009) (No. 09-10156).

126. See generally Objection of the U.S. Tr. to Debtor’s Motion for Order Approving Debtors’ Key Mgmt. Incentive Plan, *In re Lear Corp.*, No. 09-14326 (Bankr. S.D.N.Y. Jul. 20, 2009), ECF No. 161.

127. *Id.* at 1–2, 6.

128. See *id.* at 7.

129. *Id.*

130. *Id.*

131. See *id.*

132. U.S. Tr.’s Objection to Debtors’ Motion for Entry of an Order Authorizing Incentive Payments to Debtors Employees at 3, *In re Noble Int’l Ltd.*, No. 09-51720 (Bankr. E.D. Mich. Apr. 22, 2009), ECF No. 60.

133. U.S. Tr.’s Objection to the Debtors Motion for Entry of an Order Approving the Debtor’s Incentive Plan and Authorizing Payments Thereunder Pursuant to §§ 363(b) and 503(b) at 2, *In re Vermillion, Inc.*, No. 09-11091 (Bankr. D. Del. May 6, 2009), ECF No. 42.

question.¹³⁴

Another noteworthy change in the U.S. Trustee's litigation activity after the 2005 reform is that the written objections became visibly more alike, with similar allegations and complaints about the bonus plans. I can quantify this using a cosine-similarity analysis. At a high level, a cosine-similarity analysis measures the textual similarity between two documents—it can be used to detect whether, for example, documents are based on a single template.¹³⁵ To quantify the similarity between the written objections before and after the 2005 reform, I calculated the cosine similarity score of every filed objection with every other written objection and took a mean for each case. I then took the mean for the U.S. Trustee for all objections filed in each period of the case study sample. Prior to the 2005 amendment, the mean cosine similarity score for each objection in the dataset filed by the U.S. Trustee was 0.68. After the change, the mean cosine similarity score was 0.87, a roughly 28% increase. If nothing else, this analysis suggests that the written objections became much more generic and much less individualized after the change, which also required the various U.S. Trustee's offices to file many more objections than they had in the past.

One possibility is that the U.S. Trustee's vigorous, yet-generic, litigation after the reform reflects a policy of objecting to bonus plans under political pressure from Congress, and there is some public evidence of that pressure. On February 7, 2012, Senator Charles Grassley, the ranking member of the United States Senate Judiciary Committee, wrote the U.S. Trustee to ask for information on how that office's role in policing bankruptcy bonus plans was going after the 2005 reforms.¹³⁶ The Trustee responded that

[t]he United States Trustee Program (USTP) of the Justice Department vigorously seeks to enforce the [2005 amendments restricting bankruptcy bonus plans]. . . . Although all parties in interest in a chapter 11 case have standing to object to [bankruptcy bonus plans], the USTP often is the only party in a case to do so. . . . [A]necdotal evidence suggests that the USTP's section 503(c) litigation success rate before the bankruptcy courts is lower

134. BearingPoint Objection, *supra* note 41, at 7.

135. See Kan Nishida, *Demystifying Text Analytics Part 3—Finding Similar Documents with Cosine Similarity Algorithm*, MEDIUM: LEARN DATA SCIENCE (June 23, 2016), <https://blog.exploratory.io/demystifying-text-analytics-finding-similar-documents-with-cosine-similarity-e7b9e5b8e515>.

136. See Letter from Assistant Attorney Gen. Ronald Weich, to U.S. Senator Charles E. Grassley 1 (Mar. 5, 2012), <http://online.wsj.com/public/resources/documents/Letter031312.pdf>.

than its success rate for any other litigation on which the USTP maintains data.¹³⁷

IV. THE CASE FOR RETHINKING THE 2005 REFORM

This Article's account of the 2005 reform suggests that various institutional limitations and incentive problems have undermined the ability of the bankruptcy system to achieve the policy goals that prompted the reform. The main challenge in designing a further legal change that solves the issues previously identified is that many of the problems are structural. Bankruptcy judges are not suddenly going to become experts in executive compensation, and the incentives of creditors will continue to lead them to focus on larger bankruptcy issues, rather than the relatively small amounts of money at stake in discussing executive compensation. The Department of Justice's U.S. Trustee Program will continue to litigate aggressively, but the underlying problems of informational asymmetry and an expertise deficit will limit their ability to help the bankruptcy judge's deliberation.

Moreover, this Article suggests that the reform may very well have had significant negative consequences for bankruptcy practice. By driving at least some executive compensation underground, the reform may have decreased, on average, the public's view into the black box of executive compensation of Chapter 11 debtors. The reform may have increased bankruptcy costs and redistributed value from creditors to lawyers. The reform has put very real pressure on the bankruptcy judge and Department of Justice to conduct inquiries that they are poorly situated to perform, a difficult situation exacerbated by the continuing public interest in executive compensation of Chapter 11 debtors.

Of course, in a cost-benefit analysis, these flaws must be analyzed in light of the potential benefits of the 2005 reform, and the analysis above identified two potential benefits. First, it is possible that some firms that might have implemented opportunistic and unnecessary bonus plans are choosing not to do so in light of the more challenging legal path to obtaining approval of such plans. Second, it is possible that the reform may have improved public confidence in our bankruptcy system. After all, court consideration of executive bonus plans continues to invite public and press scrutiny.¹³⁸ To the extent the reform pushed boards of directors to engage in regulatory evasion to avoid the public spectacle of a hearing on

137. *Id.* at 2.

138. See Jonathan Randles, *Westmoreland Paid Millions in Executive Bonuses in Year Before Bankruptcy*, WALL ST. J. (Nov. 9, 2018), <https://www.wsj.com/articles/westmoreland-paid-millions-in-executive-bonuses-in-year-before-bankruptcy-1541804141>.

executive compensation, the reform may have helped the bankruptcy courts avoid adverse headlines. While it is possible that the reform provided some benefit by forcing the development of compensation contracts that lead managers to perform better, the evidence supporting this view is difficult to assess and nothing in this study suggests that this is the case on average. However, this Article cannot dismiss the possibility that the structure of executive compensation was indeed improved by the 2005 reform.

In light of the evidence presented in this Article, Congress and bankruptcy judges should re-think the 2005 reform. Two changes seem particularly worthwhile. First, Congress should consider providing the Department of Justice (“DOJ”) with funding to hire their own executive compensation experts who can assist with policing executive compensation. Bonuses for senior managers are an important part of modern corporate governance, and reflexive objections without detailed analysis to all proposed bonus plans are unlikely to improve the administration of bankruptcy law. The current situation would be improved if the DOJ had access to greater expertise, whether through new employees or money to hire consultants.

Second, Congress (or bankruptcy judges) should consider creating new post-bankruptcy reporting requirements to force post-bankruptcy Chapter 11 debtors to report their overall level of senior management compensation for a period of two years after bankruptcy. This will not solve all of the problems described above, but it would curtail the ability of managers to extract promises from creditors in bankruptcy that lead to excess compensation once the firm leaves bankruptcy court. Very few Chapter 11 debtors emerge from bankruptcy as public companies these days, which creates a regulatory blind spot that might be aided through additional disclosure that discourages the worst abuses, such as the example of Citadel Broadcasting.

CONCLUSION

This Article’s account of the 2005 reform is one of the most detailed analyses of an executive compensation regulation in the scholarly literature to date. As the results above show, the reform clearly appears to have reduced the usage of bankruptcy bonus plans and forced firms to style their bonus plans as “incentive plans.” However, the incentive plans that are approved create similarly sized bonuses to the retention plans approved before the reform, which suggests that the risk associated with the probability of bonus payment might not have been materially increased. This may be why incentive bonus plans after the reform appear to result in

pay-outs just as often as the pre-reform retention plans did. I also do not find evidence that the reform altered the overall level of compensation of the CEOs of Chapter 11 debtors. At the same time, the evidence suggests that the reform may have made the process of formulating a bonus plan more expensive than it had been prior to the enactment of a more demanding legal standard.

While the new statutory scheme does appear to have succeeded in giving new bargaining power to creditors, they do not, at the least, appear to use this bargaining power to inform the judge of substantive problems with the underlying bonus plan. They appear, instead, to use their right to object mostly to pursue their partisan bankruptcy interests of influencing the overall plan of reorganization. This conclusion is qualified because I do not observe the work they might do outside of court negotiating the terms of the bonus plan—work which is clearly ongoing. But it is hard to say based on the evidence that creditors are using their new governance power to make executives more accountable, implement true pay-for-performance, or reduce the overall level of compensation, as Congress intended. Indeed, more than ten years after its implementation, the putative benefits of the reform are hard to identify.

APPENDIX: METHODOLOGY FOR ANALYZING BANKRUPTCY COSTS

A team of research assistants, acting under my supervision, reviewed all of the legal bills filed by the debtor's attorneys for every Chapter 11 bankruptcy in the case study sample. For each case, the research assistants began with the first fee request and reviewed all of the bills until the time period including the day that the first bankruptcy bonus plan (in the pre-reform period, usually key employee retention plans, and in the post-reform era, key employee incentive plans ("KEIP")) was approved by the court. The review team stopped reviewing time entries after the day the KEIP was approved.

A representative example from the post-reform 2009 bankruptcy case of *Foamex International*, filed by the debtor's counsel Akin Gump, includes the following entries:

1. 03/26/09 SLN 0018 Review asset purchase agreement for Tax issues. 0.6
2. 03/01/09 AQ 0019 Emails re KEIP. 0.2
3. 03/01/09 PMA 0019 Review and respond to email re KEIP motion (.1). 0.1
4. 03/02/09 ISD 0019 O/C AQ re: KEIP. 0.7
5. 03/03/09 RJR 0019 Telephone conference w/1. Rosenblatt re Asset Purchase Agreement and relevant labor issues. 0.3¹³⁹

Time entries #1 and #5 have nothing to do with the key employee incentive plan (or at least were not written down by the attorney to reflect that they do), so those time entries were discarded by the research assistant. Time entries #3, #4, and #5 reflect work on the incentive plan. The research assistant recorded all of the time each attorney spent on the KEIP, multiplied those numbers by the court approved attorney's billing rate, and tabulated the amount the debtor's attorneys charged for work on the bankruptcy bonus plan. The research assistant also obtained the debtor's final fee applications to record the total amount billed for the bankruptcy case to understand what percentage of the overall bankruptcy costs (at least the portion owed to the debtor's main attorney) was devoted to bankruptcy

139. See Second Monthly Application of Akin Gump Strauss Hauer & Feld LLP, Co-Counsel for Debtors and Debtors in Possession, for Interim Allowance of Compensation and for the Reimbursement of Expenses for Services Rendered During the Period from March 1, 2009 through March 31, 2009, Ex. B at 14, *In re Foamex International Inc.*, No. 09-10560 (Bankr. D. Del. May 11, 2009), ECF No. 390.

bonus plan matters, before and after the reform.

The total review constituted more than 103,781 pages of attorney time entries and cover notes from 792 fee applications.

APPENDIX TABLE 1. Attorney's Fees for Implementing a Bankruptcy Bonus Plan

	(1)	(2)	(3)	(4)	(5)	(6)
	<i>Log Debtor Counsel Bonus Plan Fees</i>	<i>Log Debtor Counsel Bonus Plan Fees</i>	<i>Log Debtor Counsel Bonus Plan Hours</i>	<i>Log Debtor Counsel Bonus Plan Hours</i>	<i>Log Debtor Counsel Bonus Plan Fees as a Percentage of Total Case Fees</i>	<i>Log Debtor Counsel Bonus Plan Fees as a Percentage of Total Case Fees</i>
Post- 2005 Reform Filing	0.962*** (0.292)	0.781*** (0.288)	0.714*** (0.267)	0.636** (0.297)	0.597** (0.238)	0.747** (0.337)
R ²	0.13	0.50	0.09	0.42	0.07	0.30
N	75	69	80	74	80	74
Firm Financial Controls	Yes	Yes	Yes	Yes	Yes	Yes
Industry FE	No	No	No	Yes	No	Yes

* $p < 0.1$; ** $p < 0.05$; *** $p < 0.01$

Appendix Table 1 displays ordinary least squared regression with robust standard errors in parenthesis. Industry Fixed Effects are Fama-French 12. "*Debtor Counsel Bonus Plan Fees*" are the logged total fees in constant 2010 dollars associated with negotiating, writing, and obtaining the approval of a bonus plan. "*Debtor Counsel Bonus Plan Hours*" are the logged total hours in constant 2010 dollars associated with negotiating, writing, and obtaining the approval of a bonus plan. "*Debtor Counsel Bonus Plan Fees as a Percentage of Total Case Fees*" are the percentage of the debtor's overall bill that are associated with the bonus plan.

APPENDIX TABLE 2. Changes in Proposed Bonus Plans from Version First Filed with Court to Version Approved by Court

	<i>Pre-Reform Sample (n=43)</i>	<i>Post-Reform Sample (n=57)</i>
Bonus Plan Approved?	97.67%	91.23%
Financial Targets Raised?	2.33%	22.81%
Bankruptcy Milestone Targets Lengthened?	2.33%	10.53%
Bonus Capped?	13.95%	17.54%

Appendix Table 2 summarizes the observed changes in bonus plans from the version first filed with the court to the version approved by the judge. For example, financial targets are raised in 22% of the post-2005 reform bonus plans between the original filing on the court docket and the judge’s approval order. Bankruptcy milestones are event dates in the bankruptcy process, such as the day a plan of reorganization is approved. In 10.5% of cases, the deadlines tied to those goals were lengthened, such as giving management 180 days to obtain approval of an order selling substantially all of the firm’s assets instead of 120 days.

NOTE

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